PN-ACB-157

MANUAL FOR ASSESSING THE ROLES OF LAW AND CULTURE IN FINANCIAL REFORM:

PART ONE. FORMAL MARKETS

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PART TWO. INFORMAL MARKETS

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A report prepared for the
Agency for International Development
by the
Harvard Institute for International Development (HIID)
Harvard University

under the project
Consulting Assistance on Economic Reform (CAER)
AID Contract No. PDC-0095-Z-00-9053-00

October 15, 1994

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ACKNOWLEDGEMENTS

Acknowledgements: Many people participated in the preparation of this report. Patricia Walker provided invaluable research assistance. Susanne Mueller provided insightful comments on a draft. Meg Nipson and Katherine Yost helped with editing. Michael Roemer and Faith Montgomery at HIID, and Forest Duncan, Alan Batchelder, and Jerry LaPittus at AID, have, among others in those institutions, provided support, encouragement, and administrative oversight. Numerous AID field officers, by responding to a survey conducted in the course of research, contributed to the direction of the guidelines presented here. Important source material came from two books, edited by the Harvard Law School Program on International Financial Systems, about the role of government policy in the development of money and capital markets in East and Southeast Asia. Anecdotes have been drawn from many sources. The authors also thank the many other organizations and individuals who lent their time in interviews and in other ways for this report.

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PART ONE. FORMAL MARKETS

I. INTRODUCTION

Government officials trying to reform the financial sector often encounter an unexpected roadblock in the country's environment of law, regulation, and the judiciary (LRJ). USAID missions helping reform meet the same obstacles.

The problem is that the LRJ environment fails to provide an infrastructure that financial markets and institutions need to operate efficiently after the constraints of financial repression are replaced by the freedom and risks of liberalization. For instance, newly liberalized banks and other financial institutions will not lend as hoped, or savers make deposits, if the loan contracts cannot be enforced because contract law is inadequate, or judges unpredictable.

Little systematic analysis exists of the way the LRJ environment affects economic development, so little guidance is available to either a government or a mission looking for solutions. Of course, other factors also impede financial reform, such as a lack of fiscal discipline or an unfortunate sequence of reforms. They have drawn much more attention than the LRJ environment.

This manual is a modest attempt to address the situation. It is written for USAID personnel responsible for financial reform who are not lawyers and possibly not economists. It offers an annotated checklist of factors in the LRJ environment that can affect financial reform. The list is illustrative, not exhaustive.

Our presentation distinguishes formal and informal markets. Reforms normally address the former but not the latter. "Formal markets" generally refers to financial activities that are the object of government policy. Banking and securities are examples; so is regulated seller finance. "Informal markets" refers to unregulated financial markets. The range is broad: unofficial markets for currency exchange, contribution clubs, unregulated lending by merchants. The line between the two is very hard to draw, however. A fuller description appears in Part Two.

Financial reform, for the purposes of this report, consists of efforts by insiders or outsiders to alter government policies that:

1. control the prices of financial instruments (notably by fixing interest rates on bank deposits and loans, but also including general usury laws and rules governing price movements of securities);

2. allocate financial resources (consisting mainly of directed credit to certain sectors or groups through, for example, mandatory portfolio allocations or subsidized rediscount lines);

3. tax the financial sector discriminatorily (such as excessive reserve requirements on deposits or special taxes on financial transactions, instruments, or institutions); and

4. suppress competition among financial institutions (including barriers to entry, limits on the range of financial services, and nationalization of financial intermediaries).

Recent efforts have been directed more toward ending or reducing such policies than toward creating or strengthening them.

The legal, regulatory, and judicial environment has two dimensions. Each is very important.

a. Substantive rules govern financial behavior. They include:

    1. financial laws or norms for instruments and intermediaries; and

    2. the legal infrastructure, which defines rights and obligations in economic transactions (for example, contract law).

b. The legal process includes designing the rules, implementing them, and enforcing them.

Anyone concerned with LRJ and financial reform must be interested not only in the black letter law itself but also in how it is applied.

These guidelines offer general points supported by illustrations drawn from various countries. Our goal is to identify major ways in which LRJ could affect financial reform. USAID missions, thus alerted, can then follow up either by further analysis of likely problem areas or by addressing the problems.

This is a brief introduction, not a treatise. Many points could be elaborated to book length. The paper is short in the hope that it will be read. It is based largely on secondary sources. The presentation is deliberately simple to avoid being caught in an impossibly wide array of different reforms and legal systems.

Before presenting the main points, we review the general features of financial reform and the relative balance of formal and customary law in formal and informal finance. The five main points, each of which is elaborated, are listed below.

1. A wide range of substantive financial laws and regulations have a direct effect on reform.

2. A weak infrastructure of commercial laws can cripple financial reform.

3. Drafting is a stage in the legal process that can affect financial reform.

4. The implementation of laws is at least as important as drafting them.

5. Enforcement of laws is essential if the legal system is to support financial reform.

Stated baldly, these points should be obvious. Each, however, has many different facets that are often ignored in financial reform. Our checklist is designed to help make sure that critical elements are not overlooked.

II. GENERAL FEATURES OF FINANCIAL REFORM AND THE LEGAL ENVIRONMENT

Financial reform is important because it permits a more efficient use of economic resources. More savings can be mobilized and allocated better than before. Traditional views of finance focused on the monetary system and hence on the usefulness of money to escape the limitations of barter. More recent views focus at least as much on the intermediation function. The LRJ environment is crucial for savers to entrust their savings to the financial system and for financial markets and institutions to be able to allocate funds among competing uses in a way that deals efficiently with potential risks and returns.

If financial reform usually took place in an atmosphere of calm, with government policy makers and their international supporters thoroughly analyzing all implications of each element in the reform program, key adjustments in the LRJ environment would undoubtedly be given high priority. However, such is rarely the case. Financial reform typically takes place at a time of crisis, when the government's fiscal deficit is out of control and traditional repressive measures can no longer generate funds to fill the gap. LRJ is far from center stage, and, as witnessed by numerous failed programs of financial reform, even the fiscal deficit may not receive adequate attention. In the initial phase of reform, domestic financial savings often rise dramatically, accompanied by massive capital inflows, in response to liberalized interest rates. With all these new funds to invest, there is little concern about the government's mounting debts and even less about the adequacy of LRJ. A broad group of people start to care about LRJ only when serious problems occur.

Each of the four major elements of financial reform noted above requires an accommodating LRJ environment to provide the hoped-for benefits. Observers usually know how the existing LRJ, often cumbersome and sometimes deliberately inefficient to benefit certain participants, impedes finance by raising the costs of transactions. Regulations may require government approvals that take months, and favors, to obtain. Even more important, however, may be what is missing -- the LRJ rules and institutions needed for financial reform to work.

It is no accident that the LRJ rules and institution supporting reform are weak or non-existent.

- Before reform, when interest rates were set far below market levels with loans targeted to favored borrowers, lenders and borrowers worried little about contract enforcement to collect overdue loans. Political considerations, not contract enforcement, were the key for loan recovery.

- When there were no capital markets, and perhaps not even an over-night inter-bank money market, it mattered little to investors or issuers that rules were vague about the taxation of negotiable financial instruments.

- When financial institutions were either state owned or protected from competition, prudential regulations about excessive risk-taking and mechanisms to deal with insolvent banks seemed superfluous to depositors.

One could argue that governments should have protected themselves with sound rules, but in practice they rarely did. They relied more on command than LRJ.

The need for a facilitating LRJ environment is apparent with reforms to free up prices. Price reforms usually promote reliable information about price and risk, market interest rates not subject to arbitrary floors or ceilings, and diverse financial instruments so risk and return can be tailored to a wide range of needs. The legal system needs to play a supporting role for each aspect of these reforms. The LRJ must promote timely, accurate data. It must give appropriate incentives for risk taking. It must deal effectively with insolvent institutions or else the government will have strong incentives to curtail information that could cause runs on potentially weak financial institutions. Governments throughout Latin America, and in other parts of the world as well, have often chosen to define bank secrecy (which was originally conceived narrowly to protect depositors from arbitrary government intrusions) as broadly as possible to stop the flow of reliable information when they were unable or unwilling to deal with insolvent financial institutions.

The price reforms may be jeopardized by usury laws. It is not enough for a government to eschew direct controls of interest rates for macroeconomic purposes. The LRJ environment may constrain market pricing through usury laws that, in the name of fairness to borrowers, place ceilings on interest rates. The law's existence prompts avoidance. Together with on-going government attempts to curtail such avoidance, the law reduces the dimensions of formal finance and raises the operating costs and risks of activities in informal markets even higher and, with them, interest rates. Important information is lost to monetary authorities about the overall magnitude of financial markets and their behavior and, to formal lenders, about techniques of client selection and loan recovery that might be learned from informal agents. Here law is an impediment.

LRJ failures may undermine efforts to promote diverse financial instruments. In the early 1980s, for example, Indonesia tried to stop setting interest rates. To promote markets that would discover prices, the central bank established a weekly auction market in its promissory note. For the market to work, buyers and sellers needed an LRJ environment in which the government could not dictate prices through state owned banks. In practice, the central bank intervened and the market remained shallow.

As price reforms take hold, LRJ becomes increasingly important. For example, real interest rates commonly rise as they become freer. Higher rates may change borrower incentives and behavior dramatically in ways that force lenders to try to rely more on the LRJ system. Two kinds of defaulting borrowers could prompt lenders to turn to LRJ: borrowers who could repay but do not and borrowers who cannot. For the first group:

- When interest rates are below market, fortunate borrowers are receiving subsidies and may be not just willing, but even eager, to repay promptly if that is what it takes to maintain access to these subsidies.

- With market rates, borrowers may no longer be so eager (or so able) to repay promptly -- unless lenders are able to improve service significantly (reduce transaction costs) or pursue delinquent borrowers more effectively. Both avenues will depend on the infrastructure provided by LRJ (e.g., less expensive and more expeditious perfection of security interests and more timely and predictable enforcement of contracts and seizure of collateral).

For the second group, bankrupt borrowers, the lenders will want to collect before or after reforms. Bankruptcy procedures would be important for this category of borrowers, which lack the option of raising more funds as a going business. LRJ would have been useful and continues to be useful after reform. In the transition to markets, this group may grow as real rates rise.

Reforms to limit the government's direct role in credit allocation depend in many ways on the LRJ environment. As noted above, the loan repayment situation may change dramatically when lenders' main clients are no longer targeted borrowers receiving subsidized credits. Furthermore, lenders may have an overhang of portfolios heavily concentrated in problem loans to formerly targeted sectors (e.g., import substitution industries suddenly exposed to competition under a trade reform paralleling the financial reform). Lenders thus may need not only improved support from LRJ in making and collecting loans, as discussed, but also an LRJ infrastructure able to deal effectively with borrowers who require restructuring or liquidation (e.g., appropriate bankruptcy laws and a judicial system able and willing to deal with complex problems involving substantial enterprises).

If you "get the government out," you also need some private players in. A major justification for financial reform is, after all, to increase rather than to curtail access to credit, saving, or investment facilities, especially for marginal groups. Private players need many supporting laws, discussed below. At the most rudimentary level, foreign investors in countries like Lao PDR need clear rules and reliable ways to resolve disputes.

A number of important financial functions can be carried out far more effectively as the government withdraws from directed credit, but need the support of LRJ to reach their potential. Three examples follow:

1) Prudential regulation. Savings mobilization, for example, should become much more important when the subsidized rediscount lines that typically accompany targeted credit disappear. Intermediaries like banks and securities companies then need effective prudential rules for their customers to have the required confidence. It may be especially difficult to define related parties and thus to enforce rules against related lending. Prudential rules are critical to financial reform.

2) Rules for collateral. Some kinds of lenders seek to be able to control risks by taking collateral. Laws for mortgages and secured interests serve this end, but sometimes favor either debtors or creditors.

3) Enforceable agreements. More basically, everyone needs predictable enforcement of contracts. Judicial systems in many countries are not prepared to enforce contracts involving loan repayments in a timely and inexpensive manner, and delays erode the value of collateral.

The LRJ environment and reforms to end discriminatory taxes can also interact in important ways. Many countries impose taxes in ways that favor one financial institution or instrument over another. Taxes may be explicit -- a withholding tax on interest earned on some deposits but not on others -- or implicit -- like reserve requirements only on commercial banks. In either case, they can shape the relative growth of different types of financial institutions. Because of the fungibility of money, it is particularly important that tax laws be applied evenly to the full range of financial instruments. But the rules can be hard to change, especially as the financial sector is being reformed.

The principle of non-discrimination extends to both explicit and implicit taxes. Two examples of implicit tax are prudential rules that set capital requirements for financial institutions and monetary rules that set reserve requirements. Uneven application of either affects the flow of savings through financial intermediaries. In general, where the function -- such as deposit-taking -- is essentially the same across financial institutions, capital and reserve requirements should be similar. Thus, in a country like Korea, where reserve requirements applied to banks but not equally to non-bank financial institutions, but both took deposits, the non-bank financial institutions flourished at the expense of banks.

Financial reform itself almost always complicates the government's fiscal situation, making it difficult to end discriminatory taxes. A heavily-indebted public sector is typically the main beneficiary of interest rates held below market levels. Decontrol of interest rates can thus create pressure for higher taxes on all sectors, including the financial sector, rather than a climate for tax reform to end the discrimination and distortions that can lead to significant resource misallocation.

Governments may in practice often be quite limited in their ability to tax the financial sector. A country like Indonesia is in a particularly difficult situation because its regulations cannot readily be applied extraterritorially since liquid investments offshore can easily substitute for similar investments onshore. If the government tries to tax savings deposits, either explicitly by taxing interest earnings on such deposits as other income is taxed, or implicitly through high reserve or capital requirements, funds will simply move to Singapore. Indonesia could require its residents to pay an equal tax on income earned from the Singapore deposits, but in practice the government cannot enforce the rule; tax evasion is relatively easy in such cases. If the government exempts savings deposits from the tax, savings deposits will grow at the expense of other domestic financial instruments. Central America, and other Latin American countries to some extent, face a similar situation with respect to Miami.

Taxation of finance must also take care to tax real and not nominal magnitudes. For example, if nominal interest rates are high because of inflation, taxes on nominal interest earnings may be an astronomical burden on interest earnings in real terms. If appropriate adjustments are not made for inflation, taxes on nominal profits can easily imply a tax rate of more than 100 percent on real profits. A sales or turnover tax on financial transactions can halt the development of negotiable securities. As capital markets develop, maturities will not lengthen if the heavy penalty implied by advance withholding of tax on interest payments is not adjusted. Withholding tax raises the effective rate because it raises the present value of the payment. It may create a negative cash flow for the taxpayer when the interest due during the life of the instrument is taxed up front, as it is in some cases in the Philippines. The list of taxes and their implications is almost endless. Moreover, it must always be remembered that any tax on finance increases informal finance at the expense of formal financial markets and institutions.

Finally, <u>reforms to free up competition</u> need an LRJ environment that facilitates entry and exit as well as rivalry. Prudential rules must be applied equally to all rivals, as already suggested. Laws must permit the entry of a full range of players in banking, money and securities markets. Theoretical and empirical analyses have shown that only a relatively small number of participants, just three or four, is necessary for a market to yield competitive results so long as there are no major barriers to entry or arrangements that permit price fixing. Thus, financial reforms to break banking cartels and oligopolies must include an end to legal and regulatory barriers to entry. Untimely or arbitrary decisions about chartering new banks can be a major barrier. Prudential regulations needed to promote bank solvency, such as bank chartering requirements, must be as transparent as possible and include only essential requirements such as capital adequacy and evidence that potential owners and senior managers are competent and honest.

The LRJ's role in easing exit is equally important. Bank insolvencies may strain the capacity of the legal system in several ways. Suppose a person with an account in Bank A gives a check to a person with an account in Bank B. The recipient deposits the check in Bank B, which must then pass it to Bank A in order to receive funds to credit to the recipient's account. Bank A may offset the payment by netting it against checks it has that are written on Bank B. The payments system, the mechanism to facilitate settling these claims, must function smoothly if the banks are to do their job. An inadequate LRJ can immensely complicate this. Imagine that in bankruptcy, Bank A's trustee refuses to pay all claims on it made through the payments system by arguing that these claims have no higher priority than any other claims on the bank. Imagine too that the trustee demands that other banks honor all claims Bank A makes on them through the payment system. Netting must be enforceable, but LRJ may not provide this. A similar kind of netting problem arises in the clearance and settlement of securities trades.

Bank insolvencies can also be more problematic than those of other firms because, to mobilize deposits, banks depend not only on attractive rates of interest and good service but also on the confidence of potential depositors. Problems in one bank can rapidly spread even to other banks that were not initially insolvent. LRJ infrastructure should provide one of two approaches to potential insolvency.

- One approach, to ensure that potential depositors and other creditors have enough information for informed decisions, requires an LRJ environment that enforces penalties against those who provide inaccurate or inadequate information. The law, moreover, must place a higher priority on information than on bank secrecy.

- The second approach emphasizes careful regulation and supervision of financial institutions to insure capital adequacy; loan portfolios and other important elements of potential risk must be closely monitored. This may require a wrenching change not only in banking rules but also in the behavior of bank supervisors who previously had to pay little attention to risk. The LRJ must also enable the authorities to take effective action when needed, which may include closing banks.

The U.S. experience with its savings and loan institutions offers a number of lessons, especially about the important of speed. In particular, a "waiting game" proved very costly, as the owners and managers of insolvent institutions had overwhelming incentives to take as many more risks as possible, and even to engage in fraud and to call in political support, because they had nothing left to lose. In Chile and other Latin American countries, a long history of low-interest lending had made it attractive for borrowers to buy banks, or for banks to buy borrowers, to capture the subsidies involved. Insider lending was thus the norm and has presented an on-going challenge to reform, especially in the context of an equally long history of bank bail outs that have benefitted bankers at the expense of taxpayers.

It should be obvious that these elements of financial reform -- pricing, allocation, tax, and competition -- can be commonly affected by LRJ in positive and negative ways. All four require adequate information, for example. Workable procedures for insolvency improve pricing and allocation, as well as competition, and may reduce the need to tax profitable financial intermediaries in order to support those that are insolvent. Enforceable contracts are essential for pricing, allocation, and competition reforms; all assume that the LRJ context provides an effective contract law and a mechanism to resolve disputes. Effective collateral helps pricing as well as allocation; both reforms assume an LRJ context that protects interests in collateral.

The points that follow in the next section build on the common impact of LRJ on financial reform without drawing all causal lines in each case. The complex lines of causality prompted us to organize the guidelines according to the types of law or legal process rather than the underlying policies of financial reform. We lay out the full range without specifying relative priorities. We believe that each country's own financial reform strategy and the peculiarities of its legal system make it difficult to identify a common timeline for LRJ reform.

III. ELEMENTS OF THE LEGAL ENVIRONMENT THAT CAN AFFECT FINANCIAL REFORM: A CHECKLIST

This section describes how the major elements of LRJ can and do affect financial reform, drawing on examples from many countries in Africa, Asia, Eastern Europe, and Latin America. LRJ has two major parts:

a. The substantive rules govern financial behavior and include:

1. Financial laws, regulations, decrees, and informal norms designed for instruments like deposits, loans or securities (for example, a checking law) and intermediaries like banks, credit unions, or money lenders (for example, a banking law).

2. Commercial laws, the legal infrastructure that defines rights and obligations in economic transactions (for example, rules or statutes governing contracts, corporations, mortgages and secured transactions, bankruptcy, and public procurement).

b. The legal process is the procedure by which law is created and applied. It includes:

1. Legislative drafting, to make the rules.

2. Implementation, so that the administrative structure needed for the law to work is in place (for example, data can be gathered and evaluated or licenses given). Usually the executive does this.

3. Enforcement, so that people do what the law requires of them or what they agree to do. Usually the judiciary is key, but arbitration and non-binding dispute resolution are other techniques. The executive also plays a role.

LRJ is important not merely as written but as applied. The manual follows this organization.

A. SUBSTANTIVE RULES

1. FINANCIAL LAWS AND REGULATIONS

Many substantive financial laws and regulations directly affect reform. Inadequate or missing financial laws and regulations can hinder reform. These are the laws people usually think of when they describe the need for LRJ. The terrain may be familiar and obvious, as in the case of central bank law, or largely ignored, as are laws governing pension funds or negotiable instruments. The examples that follow are arranged by types of law that reformers must ultimately produce.

1a. Central banking law

(1) The central bank's role. In most countries, the central bank is key. As the banker for all other banks, it affects the entire financial sector. Its main job is to control the money supply by controlling reserves banks must hold with it. This allows the central bank to affect inflation, the exchange rate, interest rates, and the availability of credit. Most central banks are government agencies.

(2) Issues for financial sector reform. Four important LRJ policy issues will alert the reader to the importance of laws governing the central bank.

(a) The relation between the central bank and the central government. A key question is the degree of independence for the central bank. The central bank needs to be independent of government when setting monetary policy. The problem is common: the effect of monetary policy on the economy and interest rates can bring the central bank into conflict with the executive. The central bank may want to raise interest rates, which could increase the cost of government debt and slow economic growth, with bank political consequences. This argues for independence.

A common problem is that often one agency champions financial reform and the other opposes it, deadlocking the regulators. Some central banks want reform because they conclude that they can fulfill their mandate more effectively in a market context. The finance ministry may oppose reform to maintain its power. In other countries, the central bank may delay reforms urged by a finance ministry that takes seriously its responsibility for the entire system (the central bank is normally responsible only for banking). Perhaps, as in Korea in the mid-1980s, the central bank fears that financial reform itself would reveal the insolvency of commercial banks, which would in turn harm the central bank. A problem for financial reform arises when the law fails to settle the circumstances under which either predominates.

The law should define the relation between the central bank and the central government as clearly as possible. A balance must be found to permit independence in monetary policy without allowing the central bank to oppose reforms if it is so inclined.

(b) <u>The central bank's role as lender of last resort</u>. The central bank, as the ultimate creator of money in the economy, can make funds available to banks confronted with a run on their deposits. No other institution has this capacity. But few central banks admit to their lender of last resort function with any specificity, for fear of encouraging derelict behavior by the banks. As a result, the LRJ rarely describes the true government policy toward bailing out financial institutions in trouble. The role of the LRJ is rather to assure that the central bank has the power to act quickly. A financial reformer may ask:

- Can the central bank distinguish between insolvency and illiquidity?

- Can it close or take control of insolvent institutions fast, if it has this role? One should watch for situations where owners can challenge the central bank's action in protracted court cases.

- Can the central bank provide liquidity to solvent institutions? Failure to provide funds may force solvent institutions to close, although examples of such failures in areas like Latin America are few.

Central banks tend to be excessively generous in extending credit. To do otherwise might force the central bank to recognize losses on loans from it to insolvent banks that would endanger the central bank. Costa Rica in the late 1980s behaved appropriately. When unregulated finance companies faced a liquidity crisis, the central bank refused to bail out those that were insolvent. It did provide liquidity to solvent regulated institutions.

(c) <u>A government securities market the central bank can use as a tool of monetary policy</u>. A central bank needs certain tools. Financial reforms often drastically reduce the government's power to allocate financial resources directly. Instead, the central bank is expected to exert its influence on the availability and price of money by buying and selling government securities. This is known as open market operations.

Some central governments lack the power to issue debt instruments in local currency. As a result, the central bank has no government securities market in which to buy and sell securities. Korea, Indonesia, and Hong Kong limit the central government's ability to issue securities.

In these cases, the central bank must be able to issue its own notes. This was the solution in Indonesia and Korea. Some countries also authorized the central bank to buy and sell private sector securities. Pakistan is an example. Here private securities may substitute for government ones.

1b. Law governing deposit taking institutions.

(1) Deposit-taking institutions and reform. Commercial banks are the main deposit taking institutions in almost every country. Other institutions also take deposits (such as savings and loan companies) or offer close substitutes (such as money market mutual funds).

One goal of financial sector reform is to mobilize financial resources to fund loans. An essential element of reform is to strengthen deposit taking institutions so they provide safe liquid instruments with reasonable rates of return for savers. Savers also benefit by having more ways to invest their funds. In the absence of strong deposit institutions, savers are forced to buy property to hedge against inflation or to place their funds in other countries. Neither helps the financial system develop. Financial reform calls for safe deposit-taking institutions.

(2) Prudential regulation of deposit-taking institutions. Governments regulate the safety and soundness of banks with prudential rules. Effective prudential regulation has proved essential for providing savers with the safety they require. As financial reforms give banks greater freedom and competition, they encounter greater risk. Prudential regulation becomes more important than before the reforms. The government's lender of last resort function prompts it to make prudential regulations to protect its own exposure. Deposit insurance calls for prudential rules to protect the insurer.

The traditional U.S. approach to prudential regulation is CAMEL, the acronym for the key elements of U.S. safety and soundness rules. U.S. bank supervisors rely on examiners to evaluate the bank's

capital adequacy,
asset quality,
management depth and competence,
earnings levels, and
liquidity.

When thinking about prudential rules, one should ask if these basic elements are in place. It is not enough to know that the rules are on the books. They may have existed but atrophied during the period before financial reform.

(3) Common problems of prudential regulation. Prudential regulation varies greatly among developing countries, but some problems regularly surface:

(a) Rules governing capital adequacy of banks in most developing countries set merely the ratio of capital (shareholders' equity) to overall assets. Capital provides depositors a buffer against loss. Capital adequacy in many industrial countries is now determined according to the risk of the assets; riskier assets need more capital. A growing number of developing countries, like Malaysia and Indonesia, are moving toward this risk-weighted standard. Since capital is essentially the difference between assets and liabilities, asset quality becomes an important element in the determination of capital.

(b) Asset quality may be impaired because loans are concentrated in a small number of borrowers or made to borrowers related to the lending bank. Lending is not based on the borrowers' creditworthiness. This has happened in places as diverse as Chile and Hong Kong. Many banks can fail.

- In Spain, when the Rumasa holding company failed because the 20 banks it owned had loaned to many group member firms that were bad credit risks, the sheer size of the collapse pulled the government and financial community into the rescue. Regulators typically limit loans to individual borrowers as a percentage of capital to protect against this.

- In Ghana, the absence of lending limits put the banks at the mercy of their major borrowers, which could not be closed down without crippling the banks. This threat weakens the government's ability to reform.

(c) Management capacity may vary due to segmentation of commercial banking, where government-owned banks are treated differently from private banks. State bankers, subject to political direction, may lend without adequate regard for safety and soundness. Their books sink under a tide of bad debts, drawing in the government and its resources. One should be alert for special laws that create and empower government banks.

(d) Accurate data about earnings may be elusive because of weak accounting standards. Regulators cannot assess the banks' compliance with prudential rules because they lack reliable basic information about the firms.

(4) Prerequisites for prudential regulation. Prudential regulation and supervision may protect depositors if the government also:

- o provides full and reliable information about regulated institutions' solvency or

- o provides insurance to protect depositors.

But the choice may not be easy, as one sees in many Latin American countries (Honduras is a good example). Governments are afraid to provide adequate information. When they have neither clear legal powers nor effective techniques to deal with insolvent institutions, they take "bank secrecy" to inappropriate extremes. As in many other regions, few Latin American countries have explicit deposit insurance, yet most depositors believe they will be protected through government bailouts of insolvent institutions, regardless of the government's stated policy. Even in Chile, government denials notwithstanding, depositors believed they were protected because the government had bailed a bank out in the late 1970s. Their expectations proved correct when the Chilean government felt irresistible pressure to guarantee deposits after it was forced to guarantee the international debt of insolvent banks. This was bad for the government because it had not taken steps to limit its exposure through prudential regulation before the crisis.

(5) Some dangers of prudential regulation. Governments may use prudential controls to slip back into credit allocation. Regulators may require banks to invest a portion of their assets in government paper. Ostensibly for safety, these rules are often a form of credit allocation. Some governments go further. In Greece, the central bank used its supervision of banks to examine the entire balance sheet of the firms that borrowed from the supervised banks. In so doing, the central bank extended its control beyond banks to the entire financial system. This cut against reform.

Governments, for their part, have interests that impede reform. Reserve requirements were supposed to assure banks' liquidity by making banks hold a portion of their deposits in very liquid assets. Recent practice has been to reduce mandatory reserve requirements to a minimal level and allow banks to set their own internal reserves. Indonesia has done this. But Latin American governments are reluctant to reduce reserve requirements for fear of losing a source of interest free financing. They required the banks to hold reserves in the form of government paper. A reformer must be alert to constraints like this, which are a misuse of a legitimate policy tool.

That financial agents try to circumvent government rules is an axiom in financial circles; a corollary is that government policy will be at least one step behind the market, addressing problems of the past instead of the present. In the Philippines, to avoid the tax of high reserve requirements that earned no interest, banks created deposit instruments that were not legally deposits, hence free of reserves. The central bank's ability to manipulate the money supply was reduced as the monetary base shrank. This is one example among thousands around the world. A reformer should anticipate this behavior.

With prudential regulation so hobbled, it is sometimes suggested that laws against fraud might be a useful substitute. For the injured parties to recover through the courts requires an LRJ environment many countries lack. If a country chooses to rely more on private enforcement, the fraud laws must be clear and broad and remedies speedy. Since fraud is only one cause of insolvency, it cannot substitute fully for prudential regulation.

1c. Law governing non-bank financial institutions.

(1) Non-bank financial institutions and financial reform. In the past in many countries, financial institutions specialized in rigorously segmented markets. Commercial banks took short-term deposits and made loans to businesses and individuals. Savings banks took longer term deposits and loaned for certain purposes, such as housing. Securities companies underwrote, brokered, and dealt in securities. Different rules were designed for each class of institution.

The barriers between these types of institutions have weakened. In some cases, the lines between them were always vague. In others, market practice began to break the lines down over the last 20 years. Commercial banks became active in securities markets. Securities companies devised investments that were like deposits in commercial banks. The phenomenon has been world-wide. Financial reform seeks to break down the barriers to promote competition.

(2) The problem of differing standards. A major problem for reformers may occur when very different laws and policies govern different types of financial institutions that perform the same function, such as accepting deposits from the public. Different rules mean they do not compete on equal terms. The least regulated are likely to flourish at the expense of the more regulated. In many countries, this has led to financial crises.

The problem arises in many countries. In Thailand, only banks accept deposits and only finance companies issue promissory notes to the public, but the notes are substitutes for deposits and the rules governing the two sets of Thai institutions differ in important ways. Finance companies competing on an uneven playing field grew much faster than the banks. In Korea, the banks as regulated financial institutions were a direct tool of government policy to allocate funds. The non-bank financial institutions (NBFIs), which also took deposits, were unregulated and hence much freer in lending and pricing. The NBFIs regularly underbid the banks for the strong borrowers, leaving banks with loans to many troubled firms. In Turkey "brokers," acting legally but without adequate prudential supervision because they were not banks, offered millions of investors much higher returns than banks, then invested in high risk ventures and collapsed. Ghana's development finance institutions had a cost advantage because they were free of rules that forced banks to apply retained earnings to increase capital.

(3) A solution. The goal of reform is to assure that institutions performing identical functions, regardless of what they are called, are subject to the same rules. In laissez-faire Hong Kong, different laws governed banks and other deposit-taking institutions until 1986, when major reform brought all deposit institutions under the same law and the same regulator. All financial intermediaries that perform the same function need a level playing field for markets to work well. (This does not mean that a government should try to regulate all activities in the informal sector, as we discuss below.)

1d. Law governing institutional investors

(1) Institutional investors's role in financial reform. One goal of reform is to increase liquidity and long-term investment. Pension funds provide for retirement, insurance companies reduced certain types of risk. Mutual funds allow investors to diversify their portfolios. Each amasses large sums which they hold and trade until the buyers make their claims. These institutions can be important investors in securities.

(2) LRJ as an impediment. Laws may impede and complicate the role of institutional investors. Many countries have laws and regulations that govern the composition of institutional investors' assets. They may direct investments away from private securities and toward government securities. Singapore has required insurers to invest at least 20 percent of their assets in government securities. In Central America, insurance and especially pension funds are typically "protected" by a requirement that they hold "safe" government obligations paying below-market interest. This, of course, is unsafe when inflation is high. In Honduras, pension funds provide a large share of bank deposits, investing the rest in low interest housing loans to members.

Laws restricting private ownership of institutional investors may have a similar effect. The life insurance companies, owned by the governments of Pakistan and India, would mainly lend rather than invest. A Post Office Savings Bank in the Philippines gathered compulsory savings that were used as the government owner directed. Singapore's Central Provident Fund invested 90 percent of its funds in government fixed-income securities. Thailand gave its Mutual Fund a monopoly until recently. The result was often to reduce competition and direct pension or insurance funds away from investment in equities or long-term private debt and to the government.

Tax laws may also skew the funds' investments. Until recently in Indonesia, the tax laws enabled savings deposits to draw over 70 percent of pension funds' assets, 50 percent of life insurance firms' assets, and 90 percent of casualty insurance companies' assets.

(3) Appropriate action. One should review laws and regulations governing the way existing institutional investors allocate their resources. The reformer should also examine laws governing the structure of the pension, insurance, and mutual fund industries for ways to improve entry by new firms.

1e. Law governing negotiable instruments.

(1) Negotiability and financial reform. Negotiable instruments can be traded freely among all parties. They can be traded on securities exchanges or "over-the-counter" markets, or simply transferred from one holder to the next, usually by endorsement.

As the financial system grows in depth and diversity, it is important that instruments can be readily transferred from one holder to the next. When instruments can be traded or negotiated, their value can be determined more accurately than when they cannot be traded. Negotiability is a necessary, though not sufficient, condition for liquidity (that is, securities can be readily sold). Liquidity helps reform in several ways. New instruments can be priced better when the market value is known for instruments already issued by the same issuer. Holders of the instruments bear lower risk because the instruments are liquid, . People concerned about firms that hold these instruments -- managers, investors, and regulators -- can form a better picture of their value.

(2) The need for negotiability. A holder who transfers an instrument wants to be free of any subsequent claims based on the instrument. A holder who buys the instrument wants clear title that does not depend on the actions of prior holders. Both buyer and seller of an instrument should want a fast transfer, but rules may delay it for weeks. Indonesia has required each share

certificate to be individually signed, for example, before the transfer is effective. This consumes long periods of time. In India, traders developed a substitute scrip to trade while the underlying security was slowly being transferred. The scrip created excellent opportunities for fraud, leading to a scandal in the capital markets. A law that does not protect holders and facilitate transfer will hinder financial development. One should be alert to the effect of laws governing these transactions.

1f. Law governing capital markets.

Most countries regulate financial markets as well as the players in them. To this point we have discussed mainly the laws that govern the institutions in the markets: central and commercial banks, non-bank deposit takers, and others. Here we identify laws governing the instruments, the players, and the markets.

Capital markets are the markets for the issuance and trading of debt and equity instruments. People sometimes distinguish between short-term debt instruments, with maturities of less than one year, and long-term debt instruments. They call markets for short-term instruments the money markets and those for long-term instruments and equity the capital markets. For simplicity, we combine them here.

Capital markets play an important role in financial reform. They are an alternative to deposit-taking intermediaries, like commercial banks, for moving funds from savers to users. Capital markets increase competitive pressures for innovation and promote efficiency in the financial sector. Markets for short-term securities also supplement the banks' services, since banks use them, by providing liquidity.

The tension between reasonable caution and excessive control pervades rules for capital markets. For example, markets need to be free of manipulation for issuers and investors to act with confidence. The problem is that in the name of regulating to prevent manipulation, governments themselves may manipulate the markets. Two major examples follow:

- o To promote the markets, governments must assure that issuers disclose adequate information. Laws should permit rather than constrain this. Often they do the opposite in order to protect issuers, intermediaries, or the government itself.

- o Governments may fairly try to avoid major crises as they shift toward freer capital markets. But one must be

Most countries exempt some instruments from the coverage of their securities law to facilitate their growth (commercial paper is one example), because the risk is low (since they are short-term), or because the instrument is regulated by another law (commercial bank loans and insurance policies are examples). The exemptions often serve useful functions, but one should carefully examine their consequences.

1f(2). Rules about the trading of securities.

Rules about the trading of securities may also promote order. Many rules are essential for investor confidence. Some impair the markets, since "order" can be a code-word for government interference with supply and demand. For example:

- Many regulators or stock exchanges set margin rules, limiting the amount of credit available to finance the purchase of securities. In the United States, the central bank sets initial margin requirements as a tool of monetary policy (though it rarely uses the tool). While margin rules are common around the world, a very low ceiling for credit can suppress trading.

- Some governments use their state-owned enterprises to buy or sell securities to keep order in the markets. In France, for example, government-owned insurance companies have been directed to buy shares of traded companies to keep the price up even when it was not in the immediate interest of the insurance companies to do so. This hampers accurate discovery of prices, one function of reformed capital markets.

- To preserve liquidity, a central bank may give securities companies access to its discount window or the government may set up a specialized financial agency to lend to brokers and dealers (as in Taiwan). Sometimes crises motivate this credit. Sometimes it is made available because money markets, which would provide liquidity in other countries, do not work well. As a creditor, the central bank may gain leverage over the borrowers that could be used to allocate credit.

A reformer should ask who maintains order in the markets, the government or private agencies. Self-regulating organizations (SROs) can play important roles; stock exchanges need to impose their own internal rules. Since these rules should not substitute for government policies that reflect the broader interests of society a tension may develop between the SROs and government policy makers. In Latin America, government bureaucrats often pay excessive attention to the operations of securities exchanges, arousing much conflict with exchange officials. Some countries have reduced the authority of SROs and increased that of government agencies; Thailand, for example, recently established a Securities Exchange Commission to oversee the stock exchange. This basic question about who makes the rules should be resolved in the laws governing securities and stock exchanges.

1f(3). Rules mandating investment

Many developing countries use prudential rules or macroeconomic policies to allocate funds by mandating investment by government agencies or financial firms. At the very least, it artificially raises demand for some securities while diverting it from others. This skews capital market development and the balance sheets of the firms.

- In Korea, the government forced different groups of financial institutions to buy Monetary Stabilization Bonds (MSBs) issued by the central bank to stem inflation. The growth of MSBs misleadingly suggested a vibrant market in government bonds, while in fact the mandatory purchases deflected demand from other securities, which languished.

- Thailand's rule that banks hold large required reserves in the form of government securities issued at below market interest rates made the banks reluctant to sell the securities and take a loss, weakening the secondary market in government securities.

- Institutional investors may be directed in their purchases, as described above. For example, in Malaysia the Employees Provident Fund had to invest 70 percent of its assets in government securities.

The reformer could help government find alternative ways to resolve legitimate problems (like inflation or a large fiscal deficit) without damaging financial market reforms.

1f(4). Rules limiting buyers

Many rules governing buyers of securities also shape demand. While the capital market laws contain some of these rules, a financial reformer may be caught off guard by rules found in other laws.

- Governments often distinguish between unsophisticated and sophisticated investors, allowing sophisticated investors to buy securities subject to fewer constraints on the theory that they can protect themselves. Unsophisticated investors need protection, but the definition of sophistication must be well drafted in the securities law.

- Foreign portfolio investors' demand has been channeled by some host governments. Rules require the investors to take positions in domestic securities only through country funds, which are mutual funds set up offshore to invest in the country and are subject to negotiated limits on their activities. Korea and India have been examples. Such rules may be found in the foreign exchange laws rather than the securities laws.

- Some investors may lack the power to buy certain securities. A dramatic example was the discovery through judicial review in England that municipalities lacked the authority to take part in the swap market after they had invested millions in it.

The reformer can help the government decide if a limit on buyers serves a useful function or simply protects some group from competition. To forecast the effect of reforms, one must be alert to rules in other laws that govern buyers of securities.

1f(5). Laws governing intermediaries

Capital market intermediaries are underwriters, brokers, and dealers. The range of possible intermediaries is an important issue for financial reform. The argument in favor of a broad range is that competition lowers costs, increases liquidity, and promotes stability. Some countries, however, limit the combination of functions. Here too the capital market laws may only give a partial answer to the question of who may act as an intermediary. More of the answer may be found in other laws:

- Laws governing banks. Some countries prohibit commercial banks from directly underwriting, broking, or taking positions in most securities markets because to do so would pose excessive risk to deposits from the public. Other countries permit their banks to engage in securities transactions; the Philippines have what are called universal banks, following the European approach. The trend in many countries is toward universal banking, with safeguards.

- Laws governing non-banks. Some countries limit the role of non-bank financial institutions as intermediaries. In Hong Kong, the three functions were not well defined and the institutions that could perform them were segmented, one set underwriting, another broking, and the third dealing. Segmentation can reduce competition.

Since capital market intermediaries need sufficient liquidity to operate, attention must be paid to the laws governing money markets in the country that should supply that liquidity.

1g. The link between reform and the informal markets

Reforms in formal or regulated markets affect, and are affected by, the informal or unregulated sector. The reformer must bear these links in mind in several ways.

(1) Formal rules to protect users of informal markets. When informal markets work badly, some regulation may be necessary. This would break down the distinction between formal and informal markets. Many examples are possible:

- o In some informal markets, economic power is so one-sided that monopoly practices may undermine economic activity and create a political time bomb. One example is supplier finance, common in most countries and often unregulated. In many developing countries, merchants are an important source of credit to their customers. Where a lending firm is the sole supplier of essential goods, regulation of retail lending may be required to protect the borrowers.

- o Informal lenders often take property as collateral to secure the loan, but by definition LRJ does not regulate their claim. Regulation may be needed to prevent predatory practices such as those of a lender who promotes default so it can acquire property it holds as collateral.

- o Unscrupulous operators of Ponzi schemes, for example, pay early investors with funds received from later investors rather than with earnings. This is bound to collapse. A government may decide to extend specific regulations or general fraud rules to informal markets to help catch these schemes.

(2) Use of formal institutions for leverage over informal markets. Sometimes a reform-minded government can bring unregulated markets into the formal system. In Honduras, most informal lenders enforce their claims through the courts. The government successfully required them to register in order to subject them to certain taxes and to interest rate limits. Most informal lenders are thought to have registered to maintain access to the courts, although there is undoubtedly substantial avoidance.

(3) Financial reform and related informal markets. A financial sector reform plan must take into account the existence

of informal markets even when the goal is not to change those markets. We see several important areas.

(a) Unanticipated impact of reform. Some reforms may inadvertently impair informal markets that are otherwise working well. There are several examples.

- Reformers may decide to strengthen the laws governing collateral for loans (see below). This makes particular sense to support economic activity in the urban sector. Rural business may be much harder to reach (as it is in Lao PDR). For example, if LRJ empowers individuals to mortgage land that was collectively owned by a family or tribe, even in rural areas, it could undermine other forms of credit used for collective ownership that worked well in rural areas. In Kenya, a new system of titling supported mortgages given by individuals and conflicted with customary systems of collective ownership. Rather than improving collateral, the new system confused ownership and control of land, reducing the security of land tenure and undermining rural economic activity.

- Reforms may affect formal devices that informal lenders use. Postdated checks and sale and repurchase agreements are examples. Reforms changing the practice in the formal sector will affect their uses in informal finance.

(b) Competition between formal and informal markets. Some reforms may create conditions in which the reformed formal markets compete with the informal market. In some cases, the informal markets successfully displace the formal. For example, new regulations may require financial firms to hold more capital to reduce the risk to their customers. But capital is expensive. If lenders in the informal sector, still unregulated, do not have these costs because they are not required to hold capital by law, they may be able to charge less for their loans or pay more for deposits than the firms that are regulated. They will gain market share at the expense of the regulated firms. One does not want reform to create such anomalies.

(c) Informal constraints on formal market operations. Some informal rules, such as customary law, may penalize practices that are common in formal financial markets. Islamic laws prohibiting interest are an example. Some Islamic countries accommodate by permitting Islamic banks that do not charge interest to operate side by side with banks that do. Formal laws must accommodate this.

(d) Informal substitutes for formal markets. Informal practices may be used in place of inadequate formal institutions. In Latin America, where informal markets play an important role, social and economic ties substitute for the more formal mechanisms banks elsewhere use to select borrowers and enforce loan repayment. In securities markets, informal trading is sometimes widespread. The development of formal securities markets could benefit from studying these operations. As one designs reforms, one may be able to use these substitutes or learn from them.

(4) Financial reforms that avoid certain informal markets. Some informal activities have proved to be almost impossible to regulate in practice and are also effectively self-regulated. In many parts of the world, local savings and credit associations exist. They take many forms. An example is a club of 20 people from the same rural tribe now living in a West African capital city. Nineteen members contribute small amounts of cash to a fund which the club lends to the twentieth person. The borrower uses the money to buy a productive asset like a motorbike, a house, or a consumer durable like a refrigerator. The person repays the debt over time and the funds are loaned to other members of the club. Any group may form such a club; some flourish in government ministries.

Government attempts to regulate or prohibit these groups fail because they easily mutate to avoid control. Governments try to regulate them to control credit and, sometimes, to protect savers. In practice, members themselves can enforce their claims on errant debtors through extra-legal means that may be social or familial. The clubs play a vital role collecting savings and lending small scale. Their lack of red tape and regulation are a strength. Financial reformers are best advised to avoid trying to control these clubs.

2. COMMERCIAL LAWS

Other laws governing business activity affect reform. As the following paragraphs show, some are almost as important as laws directly governing financial institutions. Without them, reforms could well fail.

This section identifies crucial commercial laws. We very briefly describe the law, then explain its relevance to financial reform. Our purpose is not to give an exhaustive overview of each law. Once one is aware a problem may exist, one should turn to specialists in that law for help, perhaps with the guidance of lawyers at USAID.

2a. Contract law

Parties to financial transactions need the ability to define their mutual rights and obligations and predict accurately that their agreement will govern their relationship. This is so basic that without it formal financial markets and institutions would be minimal. Borrowing and lending, depositing and deposit taking, and buying and selling of financial instruments could only take place though personal and social relationships. Informal finance would dominate.

Contract law is essential for parties to a transaction to know what makes their agreement valid and enforceable.

- o The existence or adequacy of the law itself is most likely to be at issue in a transition country that abolished all formal laws at the time of the Communist revolution. Lao PDR is an example.

- o Most countries have a contract law. For them, the important question is whether the contract can be enforced. Of particular concern for financial contracts, given the extent of innovation today, is whether instruments and activities not mentioned in the law have legal status. This may be a matter of contract law, as in Latin America, or government policy, as in some Asian countries.

2b. Laws governing collateral

A major goal of many financial reforms is to swell the flow of credit allocated by the market. Specifically, banks should lend according to criteria of risk and return rather than government directives. One step is to let lenders get good collateral, particularly for urban or commercial loans (for the reasons discussed above). They can reduce risk by using assets as collateral for their loans. The inability to create mortgages or transactions secured by other property will impede the reforms. Indonesia, India, and many other countries, including those in Eastern Europe, have this impediment.

Laws governing collateral may be inadequate to their task for several reasons.

- o The holder's interest in the secured property may not be well defined. The constitution itself may permit a private person to occupy land but not own it, so the person cannot give a mortgage. Some former Communist countries have this basic rule. When only a possessory interest in a physical asset is allowed, a small business cannot obtain accounts receivable financing.

- o Mortgages may be very costly to create for several reasons: high registration fees, a time-consuming process, government inefficiency, and graft raise the price. Costs rise even higher when the credit is subsidized. The subsidies create excess demand, so lenders have to ration credit. They do so by raising the transaction cost through strict collateral requirements. One sees this in some Central American countries, for example.

- o Collateral is not worth much if social or political forces prevent lenders from possessing or using it. Private banks in Indonesia, for example, have been unable to collect on good collateral securing loans to a politically important manufacturing company.

What makes good collateral in one setting may make poor collateral in another. Costa Rica has an efficient collateral process in its personal property mortgages against cattle. Costs and delays are relatively small and it is not politically or socially difficult to take away someone's cattle. Punishment is quick and severe if the collateral disappears.

By contrast, in most of eastern Africa, cattle have too many important cultural meanings and social uses to be easy to seize, and these make them poor collateral for institutional lending.

Reforms to improve the use of collateral must assure that lenders cannot abuse their position by using debt as leverage to acquire full ownership of the collateral. This has been seen as a problem even in the United States.

2c. Bankruptcy law.

Reforms to stimulate the flow of debt and equity within a market economy need good bankruptcy law. It further clarifies the risks of different stakeholders in a company. Bankruptcy law sets priorities among claims on a debtor by different classes of claimants, such as:

- equity investors,
- lenders,
- workers, and
- government as tax collector.

Higher priorities give greater likelihood of payment when the debtor cannot pay all its debts. Laws that prefer creditors over debtors allow insolvent companies to be closed more readily than laws that favor debtors.

The economic effect of a good bankruptcy law is to define in advance the conditions under which marginal producers exit from the marketplace. Bad laws would delay exit, forcing creditors to subsidize insolvent firms to keep them afloat, undermining competition in the industry, destabilizing sound firms, and weakening the lenders' assets more generally. Investors would try to avoid this morass. Financial reform would founder.

Reforms to strengthen financial intermediaries also need effective bankruptcy law.

- o Problem loans bedevil banks in many countries and stymie financial reform. When banks carry many bad loans on their books, good bankruptcy law helps resolve the status of both insolvent debtors and, in some countries, troubled banks or other financial intermediaries.

- o Capital market reforms call for brokers to facilitate trading, which must take place quickly. Brokers hold the assets of many customers. If a broker becomes insolvent and customers' assets are tied up in litigation for a long time, the market itself can be hurt. Many countries subject brokers to rules that would close and liquidate them quickly if they become insolvent. The purpose of this procedure is to allow trading to proceed with a minimum of interruption. These rules must fit the bankruptcy law.

The reformer should realize that bankruptcy laws based on Western models assume a debtor's assets can be valued and that courts are capable of enforcing the law. These assumptions may not hold in many countries undergoing reform.

Bankruptcy laws may not be enforced for economic or political reasons:

- o In many countries, such as those in Eastern Europe, so many large debtors are insolvent that the normal operation of a bankruptcy law could imperil the entire economy and the banking system. Countries such as the Czech Republic have been reluctant to enforce their bankruptcy laws as a result.

- o The political clout of a debtor may also emasculate a bankruptcy law. One example is from Indonesia, but could be drawn from many other countries as well. A government bank encouraged other banks to lend to a company. The borrower, a large employer, encountered difficulties.

Banks would normally classify their loans to such a borrower as problem loans. But since the government did not want the borrower to fail, it used its bank to press private banks to lend more rather than classify the borrower.

It is not enough to have a bankruptcy law on the books. The law must be one which the government is willing to enforce.

2d. Company law

Reforms to develop debt and equity markets assume that in almost all cases the investors are at risk for no more than their investment. That is, investors in firms issuing securities can limit their liability in an issuing company. Investors would be very cautious if their equity holdings in a company entitled its creditors to make claims against the investors' other assets. Certainty about the extent of possible loss (the equity stake) allows potential shareholders to define their risk when they invest. It helps creditors like banks define their risk when they lend.

The company law usually limits shareholders' liability to their existing stake in a company. It may also fix the responsibility of participants in entities other than corporations, such as partnerships. The law should answer several related questions. Many raise issues of corporate governance, which concerns the way companies are directed.

- Under what conditions is a shareholder's liability not limited to the investment? Sometimes the corporate veil can be pierced to hold the shareholder liable for more.

- What are the shareholders' rights when the company issues new stock? This was a problem in Thailand, where the company law substantially slowed the offer of stock by companies with shares that were not publicly traded by giving existing shareholders a right of first refusal.

- What are the obligations of majority shareholders to minority shareholders? In some Latin American countries, laws are either so lenient that no one wants to be a minority shareholder or so strict that no one wants to sell to minority holders. This impedes the development of stock markets in the region.

- When control is dispersed among members of a financial/industrial group, should special rules govern the controlling shareholders? Groups are a major force throughout Asia and Latin America and are forming in the transition economies.

- What information are large shareholders obliged to disclose because of their control?

- Should existing shareholders with control be protected in any way during hostile takeovers? Some European countries require notice to the target company from those seeking the acquisition. The problem is that existing managers may then use this information to delay the takeover effort. This issue arises when the European rules serve as models for transition countries' laws. Since some of these issues may arise with laws for securities and stock markets, their fit with the companies law must be carefully aligned.

The answers to these questions will depend on the kind of economy the government wants.

2e. Administrative law

Financial reform calls for the government to act fairly and quickly both as a player in and a regulator of financial markets. Governments issue, buy, and sell securities on their own behalf. They also regulate. This raises a potentially serious conflict of interest since the government will, in most cases, be one of the biggest players in financial markets. Government employees involved with financial markets may also see opportunities for self-enrichment. These problems must be eliminated to sustain market confidence. Without that confidence, investors will either demand higher returns to compensate for the cost of government graft or refuse to invest in order to avoid the risk. Either response hurts the reforms.

Administrative law governs the acts of government employees. It raises different problems for financial reforms in different situations.

- In transition economies lacking such laws, the idea of a neutral regulator is discredited. The widespread belief that officials are corrupt extends to public sector financial institutions, undermining reform. Few officials in the country seem to see that the need for effective laws is great. One reason may be that the laws run counter to their self-interest. Little local support exists.

- In many Latin American countries, administrative laws create serious problems. The salary and employment rules make it very difficult for public sector financial institutions, including regulators and even the central bank, to pay salaries competitive with the private sector, to fire employees who are not performing or when cutbacks are necessary, to make purchases expeditiously, or to privatize. Crucial reforms cannot proceed.

One must be alert to the effect of these laws by either their presence or absence.

2f. Land laws

Land laws define ownership and other interests in real property and give ways to establish an interest, transfer it, and resolve disputes among claimants to land.

Land laws are important to financial reform in several ways:

- One must establish one's interest in property to use it as collateral for credit, as described above.

- A major function of a market-oriented financial system is to finance the development of residential and industrial property. But banks cannot lend readily if developers lack clear title to their land or the ability to use it as desired. Some transition countries retain laws from the communist era that limit individual owners' interests in land and obscure the state's ability even to define the nature of its ownership interest, which is needed to transfer the property to private persons. Even new land laws may not resolve all the issues. When Poland, for example, privatized, the central government could not transfer its title to state property directly to private persons. Since local government could do so, the central government had to transfer state property to the local governments and allow them to sell their stakes to private persons.

- Land use rules also affect demand for financial services. Poland had to change its controls limiting land use to make the property attractive to buyers. Some use restrictions are particularly onerous. Madagascar, among others, carries laws that forbid speculation in land. Such a rule may reflect the local culture or an anti-capitalist ideology. But how does a lender distinguish between speculative and productive uses? Severe penalties would constrain lending by increasing the risk of default if the state acted to enforce anti-speculation laws.

Financial reformers should encourage land laws that give clear title and allow broad use of property. This is particularly important for urban residential and industrial property and for property in the formal agricultural sector. For the reasons described above in the section about collateral, rural land held collectively may require special treatment in many countries.

2g. Tax laws

Tax laws are discussed in Part II above. The message for reformers is that tax laws should have a neutral impact on financial instruments.

2h. Trust laws

Reforms call on financial intermediaries to perform a variety of functions on behalf of customers without taking title to the customers' property. Brokers, for example, must be able to hold customers' funds and securities separate from their own in order to trade securities for others. If they do not, then in bankruptcy the customers' property may be available to meet claims on the broker. Investors would be wary of using brokers, which would undermine efforts to develop capital markets.

- o Common law countries, with an English law tradition, typically have laws that protect against this danger by permitting one person to hold assets for another in trust, separate from the first person's assets.

- o Countries that use European code law, such as Thailand, often lack an adequate legal concept of trust. To deal with this problem, Thailand incorporated the concept in its new securities and exchange law.

Sometimes trust law permits excessive flexibility. This seems to be the case in Latin American countries. In countries such as Bolivia and Guatemala, financial intermediaries use trusts to offer deposit substitutes that avoid reserve requirements on deposits at banks. The trust is a device to avoid reforms.

Trust laws can increase the flexibility of financial intermediaries but that this flexibility needs bounds.

2j. Tort laws

One rarely thinks of financial reform and tort law, which defines non-contractual obligations for damages. But in Madagascar, a weak tort law prevented insurers or businesses from evaluating risk. The insurance industry atrophied. Without being able to identify what they were being insured against, prospective customers withdrew from the market. Insurance companies are an important set of institutional investors and the development of capital markets is a common element of financial reform. But the exercise may be thwarted if demand for insurance is limited by the state of the law.

2i. Competition law

A government that ends its interest rate controls as part of financial reform may be surprised to discover that rates do not move freely. One reason could be the inadequacy of laws to assure that firms in an industry compete with each other (called anti-trust laws in the U.S.). This happened in Turkey. After the central bank freed interest rates, the large Turkish banks agreed among themselves to set deposit rates below market. One solution is to allow new entrants to swell the number of competitors. Another is to apply to banks a competition law, which commonly makes price fixing illegal.

Competition law may prevent collusion when interest rates are freed up.

2k. Customary and religious law

Few countries offer a clean slate for new law. Most developing countries have the law of their former colonial power and most transition countries have laws from the Communist era. Western Europe is the source of these laws. In addition to them one usually finds religious or customary laws. In Africa, laws of the tribe and Islamic law may co-exist with law derived from the former colonial power. In Central Asia one may find Islamic law in addition to laws that once governed the USSR. One person or transaction may be subject to more than one set of these laws. The financial reformer must know the circumstances that prompt the application of one set or the other. This means financial reforms must look to specialists in local customary or religious law for guidance.

B. THE LEGAL PROCESS

1. DRAFTING

Many financial reforms require new law of the sort described above. Drafting each law consists of framing the appropriate language and putting it in the appropriate form. One may have to draft an entirely new law or new sections of an existing law. USAID project staff or consultants may prepare the initial draft themselves or simply comment on a draft prepared by the government. The government agency responsible for the draft may be a substantive ministry (such as the finance ministry), the ministry of justice (which often reviews all draft laws), or an interministerial group such as a cabinet of ministers.

USAID and other donors have supported drafting by providing several types of assistance:

- a U.S. lawyer living in the country as a resident legal adviser who participates as a generalist in the government's drafting sessions for various laws;

- specialists in a specific law, like U.S. securities lawyers or law teachers, who visit the country, meet key officials, and determine the country's needs and capabilities, then return home to draft the law; or

- commentators who remain in the U.S., such as members of an advisory group in a U.S. bar association, and review drafts sent to them.

These types of assistance are combined in various ways.

Legislative drafting raises generic issues of which it is important to be aware. Attention to these when designing any assistance program will produce a more effective law. The following points come from experience in countries around the world.

1a. Local participation

One should not expect to transplant a foreign law with little change, particularly one from an industrialized country. While not all laws require compete tailoring to local circumstances, foreign experts drafting laws for a government should raise all important issues that require decisions about policy. If the experts make the decisions and local officials do not, at least two problems may occur.

- The law probably will not address local conditions. One could find a complex U.S.-based securities law, for example, in a country with a stock exchange that meets once a week for two hours.

- Government officials, not having anticipated the implications of the law, may not be prepared to apply it when it is challenged by groups it affects. A well-known examples is the Japanese law against unfair competition. It was drafted during the U.S. occupation after World War II to prevent concentrated economic power but rarely enforced by the Japanese later. Such a law may look good on the books, but it will be unenforced.

Major policy issues confronted in drafting should be resolved by senior officials in the country early in the process. Local counterparts are essential.

1b. Education

Laws like those described in this report will not automatically win broad support. People who are affected -- especially those who may be economically hurt -- must be convinced of the value of the changes it will bring. For example, suppose a country with a going exchange needs a new stock exchange law. The new law will set new standards for licensing and organizing stock exchanges. If these are very costly to the existing exchange or if it cannot comply, the exchange, its owners, and many of its users may oppose the new law. When the government debates the law, in public or private, supporters of the law need to be able to respond to its opponents. The reformer must educate supporters of the law so that they can win enough local support to pass and implement it.

This education starts with those government officials who are immediately involved with the drafting as described above. It must extend beyond them to others in the executive and legislative branches as well as the concerned commercial interests. The foreign consultant must be guided by local advice about whom to educate. This process should be built into any program.

Drafting is an iterative process that must educate an ever widening circle of people in the country.

1c. Models

Laws offered as models to many developing countries hale from different nations with different legal systems. The most obvious divide is between common law and code law.

- o Common law can be thought of as bottom up, based on judicial decisions in many cases as well as individual laws. It is found in English speaking countries.

- o Code laws may be thought of as top down, applying general principles rigorously to all branches of the law through legislation. Europe is the source of contemporary code law.

While differences between common and code systems may be less profound than in the past, they still complicate efforts to create an integrated body of laws in a country.

For example, imagine a country with many different sources for its financial laws:

- a commercial code from France enacted during the colonial years,

- a banking law from the United States,

- a securities law from England, and

- a foreign investment law from Japan.

Drawn from different legal systems, these laws may use technical terms, for example, in different ways. The terms 'bank' or 'usury' or 'security' may have different meanings in each. Which takes precedence? The confusion may discourage domestic and foreign investors.

If laws fail to mesh, their combined effectiveness is reduced and the reforms undermined.

- o The problem is severe in transition countries, which are often bombarded with laws from leading donor countries.

- o But even Latin American countries, with entrenched code systems inherited from Spain and Portugal, have problems. New laws copied from other countries, for banking or central banking for example, may not mesh with each other.

Coordination among donors should be mandatory because officials in many recipient countries lack the skill or time to coordinate by themselves.

Reformers should recognize that multiple legal models for drafting can complicate the implementation of financial laws.

1d. Specificity

Financial reforms often call for policy decisions despite great ignorance of how markets will evolve. Legislation passed by an assembly may be hard to change for political reasons, so drafters know the law could remain unmodified for many years.

Faced with uncertainty about the effects of different approaches to important issues, drafters may prefer to leave some issues unresolved and delegate important decisions to the government agency that will implement the law.

- o Sometimes delegation is essential. For example, a law prohibiting banks from lending to insiders could state its intent clearly but leave officials and the courts to apply this law in specific cases. No law could anticipate all types of insider lending.

- o However, a matter like the authority to grant banking licenses should be very specific about materials applicants must submit to obtain the license. Otherwise, the licensing agency is in a position to abuse its authority.

The reformer should be wary of broad or general laws. Specificity in laws promotes predictability by limiting discretion of administrators. Broad delegation to government officials should be the exception.

1e. Types

Law takes many different forms. Usually, legislation is law passed by an assembly or congress. Decrees are not; rather, they are issued by some senior member of the executive branch of government, such as the president, prime minister, or other cabinet ministers. Regulations may be promulgated pursuant to legislation by designated agencies in the executive branch. They may be designated in many different ways. Sometimes types are combined, as in "decree-laws."

For financial reform, an important question is which type of law to use. One trade-off is between speed of passage and longevity after passage. Decrees may be issued faster than legislation. Only one minister may be needed to make a decree. Many legislators are needed to form a majority, which slows both passage and amendment. One should determine whether speed or longevity is more important.

Another issue is whether decrees are valid only under certain conditions, such as that the parliament is not in session when the decree is issued. These limits are designed to limit the executive's power. One should assure the conditions are met.

The relative priority of the various laws is a very difficult problem. It is not always clear which type of rule takes precedence over another, yet it may be very important to financial reform that certain laws govern. A worst case has critical elements of a good financial reform law being superseded by a harmful decree issued solely on the initiative of the finance ministry.

The reformer must be aware that not all laws are the same. Local lawyers or government officials should be consulted early on.

2. IMPLEMENTATION

Laws must be implemented to be useful. Government officials must be able to act as regulators, supervising the financial intermediaries or managing registries (of companies, for example). Lawyers must be available to advise parties to contracts or about procedures called for by the law. A financial reform project must devote thought and resources to implementing the new laws.

The implementation of laws is at least as important as drafting them, but often it is ignored.

2a. Regulators

Regulators are the first line for implementation. For example, a new law setting prudential standards for banks or securities companies requires that the finance ministry or central bank assign good people to carry out the job.

- Regulators with skills such as accounting that were not needed in the old regime will be needed to apply the new prudential rules

- Enough regulators must exist to implement the rules credibly. Two bank supervisors, for example, will not constitute enough of a force to make the bankers in even a small country believe that the new prudential rules will be applied. The two could not examine the banks' books in sufficient detail.

If the agencies do not pay adequate attention to implementing prudential rules and supervision, governments may later face the choice of bearing large losses or watching their financial system collapse. Projects to strengthen the bank superintendencies are underway in countries in many regions. Central and South America are examples.

Governments must assure that regulators are equipped in several ways:

- basic training,
- adequate salaries, and
- enforcement tools that range from moral suasion (or jaw-boning) to the authority to issue cease and desist orders, remove bank managers, apply civil penalties, and even revoke charters. (See Section 3, below, on enforcement.)

For example, a regulator who can issue cease and desist orders without prior court review can move quickly to protect an insolvent bank's remaining assets and depositors without being tied up in lengthy litigation. Regulators lack such authority in many countries. Ghana is an example. Regulators there could not impose penalties strong enough to deter violations. The laws could not be administered properly.

Lack of training may discourage implementation of new laws. Regulators untrained in bank management may be reluctant to seize control of an insolvent financial institution because they will have to run it, sell it, or liquidate it quickly, none of which they are able to do. The much needed exit of insolvent banks does not occur.

Financial reform must help governments field skilled personnel with power to implement prudential and other regulations, including the examination of financial institutions.

2b. Registrars

Several of the laws included in this report call for registries. Companies must be registered to comply with the company law. Title to land must be registered. Secured transactions may need to be registered to be binding on other creditors.

A critical issue is the extent of the registrar's discretion. For example, in the case of the companies registrar, is the document to be registered treated as a contract between private parties or a charter conferred by the state?

- If it is a contract, the registrar merely checks to assure that all required information is provided. Discretion is limited.

- If it is a charter, the registrar has substantial discretion to decide whether to grant it. This easily opens the door to corruption.

Financial reformers should ensure that registrars are neutral repositories of information.

2c. Systems

Systems exist for the safe cheap transfer of checks, other claims on banks, and securities. A payment system gives banks common processes so that the check one person writes another actually results in the transfer of funds from the payor's account to the payee's. A clearance and settlement system enables the owner of a security to transfer ownership to another and to receive payment as agreed. Delays in the payments system or the clearance and settlement system increase the costs and risks of the users, sometimes substantially. Financial reform often addresses these problems.

Laws to strengthen financial systems often set timetables for payments systems and clearance and settlement systems. Laws for securities trading, for example, may require settlement on the third day after the trade (T+3) and payment at the same time (delivery-versus-payment), to put the country's markets in line with the practice in many other countries. Several Southeast Asian countries have such rules and the U.S. has set this as a goal. But even with a legislative mandate, DVP on T+3 will not happen if the financial intermediaries lack systems with the appropriate technology and trained personnel. To the extent that government institutions are involved, as when the central bank runs a book entry system for trading in government securities, government personnel need training and the appropriate technology. Countries in the former Soviet Union, such as Kazakhstan, have had to acquire these systems.

Legal changes to improve systems for payments and clearance and settlement need skilled personnel and technology in and out of government to implement policy.

2d. Personal Liability

Industrial countries may take for granted the ability of staff in financial firms and the government to carry out their official responsibilities without placing their own assets at risk. This is not always the case elsewhere.

In Taiwan, bank loan officials could be criminally prosecuted if their loan portfolio went bad. This exposure would make the officials very reluctant to take even minor risks when making loans. Risk is inherent in lending, however, and some loss is to be expected. Rules of this sort dampen the efficiency of credit markets.

When the Philippines tried to strengthen financial institutions by weeding out insolvent banks it appointed a finance ministry official to close the problem banks. The country's laws permitted shareholders of closed banks to sue the official in his personal capacity and claim damages from the official's personal property. This would give the official a strong incentive to be extremely cautious closing banks. The banks' problems would not be solved and basic financial reforms would be stymied. This created a very serious problem in the Philippines.

An official's personal assets must be insulated from his or her official acts.

2e. Information

Two sorts of unreliable data may hinder financial reform:

- data about the financial condition of firms, and
- data about the laws and regulations themselves.

The first is a major barrier to reform around the world. In some countries, the auditing and accounting professions lack good generally accepted rules and practices or competent professionals. Regulators as well as users of the financial institutions cannot assess risk accurately.

A very different problem occurs when the government does not routinely publish its laws, regulations, or other pronouncements. In Madagascar, old statutes still enforceable were unobtainable, and new laws (on bankruptcy, for example) and cases were not reported. Elsewhere, ministerial decrees have been promulgated but not published until the ministry decided that the decree would be acceptable to the rulers. Since the decree was promulgated, it bound individuals even though they could not know about it.

Ignorance of legal reforms will jeopardize the reforms. Special decrees derogating from the reforms will undermine them.

One solution is to require that rules be published in a national gazette to be binding.

Incomplete or unreliable data undermine implementation of laws affecting financial reform.

2f. Regulatory responsibility

In most countries, several government agencies are responsible for financial policy: the finance ministry, central bank, a securities commission, and perhaps others. Their relative roles making and implementing policy vary. Turf battles among the agencies can undo reform.

Uncoordinated multiple regulators are a common problem in many countries. Overlapping authority and policy contradictions confuse the markets and permit competition in laxity.

- o In Malaysia in the early 1990s, the central bank was the single supervisor for commercial banks, merchant banks, and quasi-banks but six different agencies regulated various parts of the securities industry. These included the companies registrar, the capital issues committee, the foreign investment committee, the panel on takeovers and mergers, the commodities trading commission, and the central bank. Malaysia's solution was to establish a securities exchange commission for one-stop regulation of securities. But the underlying threat of turf battles among finance ministry, central bank, and securities regulator remained.

- o In Indonesia, policy debates between the finance ministry and central bank slowed financial sector reform by years.

- o The U.S. raised the problem to a fine art, creating one of the world's most complex federal and state systems to regulate banks and securities companies.

The problem is built in. Bank regulators are more concerned with the safety and soundness of individual institutions, while securities regulators look more to the markets and the investors. But banks are usually active players in the securities markets. No one form of organization has been found to resolve this problem. Japan houses its banking and capital market regulators in the finance ministry, yet they compete fiercely.

The reformer should encourage clear allocation of regulatory responsibility to minimize turf battles between the finance ministry, the central bank, and the securities regulators.

2g. Consensus building

The mere fact that an elected assembly passes a law does not ensure that people will abide by it in many countries. Westerners may believe laws should exact obedience from the date they take effect. They would not accept that a government continues to condone behavior a new law prohibits. Yet governments in many countries may not be prepared for what they see as draconian enforcement. The extreme case is the bankruptcy law that cannot be applied without closing much of a country's firms and putting many people out of work. It will not be applied.

To inculcate a respect for laws enacted as part of financial reform, their phase-in should reflect local conditions and practices. It may be more appropriate to build consensus gradually rather than simply command obedience.

2h. Skilled local lawyers

As many new laws for the financial system take effect, private sector firms and individuals need to know their content and effect. But high lawyers' fees may raise the cost of implementing the law, creating a barrier to financial sector reform.

- The high cost of local lawyers may stem from their short supply. Few lawyers will know much about the new laws, for example.

- Their high cost may reflect barriers in the old financial system that is being replaced. For example, in countries where banks rationed subsidized credit by raising transaction costs, lawyers too collected large fees and behaved inefficiently.

People in the private sector need counsel skilled in the policy of the new financial laws. The donors' tendency to concentrate on legislative drafting funnels resources to the local government. A reformer must address the need for private lawyers as the market economy takes hold.

3. ENFORCEMENT

Suppose people know that a financial law or a financial contract is unlikely to be enforced. They will not respect it, however well it is written. They may look to several different forms of enforcement:

- Laws invoking criminal sanctions are normally enforced through the courts.

- Other laws or agreements made according to them may be enforced through the courts or less formal means such as arbitration or mediation.

- As a substitute for formal enforcement, parties may rely on their on-going business or social relations to assure performance. A borrower will repay one loan on the agreed terms in order to be able to get another from the same lender.

Even if informal relationships are largely effective, reliance on them for enforcement encourages financial transactions among related parties but not among otherwise unrelated parties.

A common complaint is the time it takes the courts to resolve disputes. The complaint is not limited to developing countries. English speaking lawyers like to say that the wheels of justice grind exceeding slow but exceeding fine. Others answer that justice delayed is justice denied. Certainly in finance speed is critical. Efforts to solve the problem by legislation may not work. In one African country, despite a law requiring that commercial suits be decided within ten months after starting, the courts routinely delayed long beyond the deadline.

The following points should alert the reformer to possible enforcement problems.

3a. Judicial integrity

The crippling effect of a corrupt judiciary is visible in country after country. Even a valid loan contract has limited value if courts will not enforce it. Financial reform laws become exercises in futility.

Courts are easily corrupted if judges are poorly paid. Stories abound of countries where the favorable decision goes to the party willing to pay the most. But often more is at play than simple corruption, so simply paying judges well and giving them tenure may not be enough. Family ties, for example, may be so strong in the culture that a judge cannot be independent.

Judicial integrity requires adequate pay and a political climate that accepts it. The financial reformer may help at least achieve the former.

3b. Judicial independence

Even in the bastion of judicial independence, the United States, judges are known to read the newspaper. But in many countries the judiciary is not remotely independent despite constitutional guarantees. New financial laws or contracts may require judicial independence to be enforced.

Many countries give the justice ministry power over judges. Madagascar is an example. The constitution gives the court a rank equal to the other government branches, but courts lacked the power to assert equality. A project in 1992 proposed ways to deal with this: appoint judges for life, allow judges to express their own opinion of the law in court (rather than give an executive branch opinion), and set up a judicial ombudsman staffed by members of the assembly, executive, and courts. But the ministry of justice, which oversaw the judges, remained able to transfer them without consent and it was not clear the ombudsman would get adequate resources. This was at best the first step toward a more independent judiciary.

Direct political interference is common, but more subtle forms of dependence may be missed. In China, for example, the low bureaucratic status of local judges hobbled commercial cases. The country had a largely state-controlled economy, so economic and financial cases that came before a judge often involved a state-owned enterprise as a party. Officials in the enterprise or local senior government officials to whom they reported often held a higher rank than the judges, who were also part of the government. With their careers at risk, the judges were understandably reluctant to decide against the state enterprise. Most cases went to the state enterprise.

This behavior depresses financial sector activity. To the extent that lenders, for example, could anticipate it, they would be reluctant to lend to state enterprises. Indeed, in many Latin American countries where the president or a senior minister decides if a state enterprise will repay its debt, the private sector does not finance government entities. One might say that this reflects state enterprises' lack of creditworthiness. Part of this is due to the inability of courts to enforce contracts the executive wants to disregard.

Judicial independence from executive or legislative pressure is hard to achieve. A first step toward independence is long-term appointments, the ability to express opinions, sufficient rank in the government, and control over resources. The USAID financial reformer may turn to U.S. judges for help, but must bear in mind that many countries have very different forms of government.

to an agreement. Courts would enforce the arbitrator's decision without a full review of the underlying facts.

- o Mediation attempts to resolve disputes without resort to compulsion.

Some financial activities regularly use arbitration; many stock, futures, or options exchanges resolve disputes among brokers or between a broker and customer by binding arbitration. They do so to decide disputes fast so brokers can get on with their business, as described above.

An arbitration law enables courts to enforce arbitrators' decisions without a full review. The law sets the qualifications for arbitrators and specifies the essential characteristics of an award, such as the reasoning, timing, publicity, appeal, nullification or enforcement, and effect of one party's default.

Arbitration is limited as a substitute for courts. It is inappropriate for enforcing criminal penalties. Designed to resolve disputes between parties who agree to it in advance, it is not suited for many other types of disputes. But it may be used to enforce financial agreements when the courts are unable to act.

The financial reformer will find several Western groups that specialize in dispute resolution and have experience in developing and transition countries.

3e. Police Power

Even the best decisions, by honest skilled independent judges, require the executive to enforce them. In some cases, the executive may be unwilling.

The problem of an unwilling executive reaches beyond judicial/executive relations to regulatory agencies within the executive branch. Regulators charged with enforcing a law may find they lack the support of key government players. In Honduras, for example, the Superintendency of Banks has often detected that certain banks are insolvent or have failed to comply with regulatory requirements. But it can only draft a letter to the delinquent bank. The Monetary Board or the President of the Central Bank must decide whether to send it.

In other cases, the executive may be unable to enforce a decision. For example, when a mortgage claim is being enforced after litigation and a favorable decision, neighbors of the obligor may prevent the forced transfer of land to an outsider just by physically blocking it. The local police may be unwilling to intervene for political or cultural reasons. In this example, the mortgage law may be well designed and the land law properly implemented, the courts do their job, and still the formal financial system is undercut.

The financial reformer must, at the very least, ascertain whether the judiciary can rely on the executive branch to enforce a decision and whether regulators can rely on others in the executive to do so. If not, self-enforcing mechanisms should play an important part in financial reform.

3f. Cost

If the costs of litigation are too high, an aggrieved party will not be able to enforce a contract or rights granted by law. The aggrieved parties must be able to afford to enforce an agreement.

The financial reformer must pay close attention to the cost of using any system of dispute resolution, through courts or others.

3g. Traditional authorities

Traditional authorities may be useful or even essential agents of enforcement. This brings us to the next part of this manual.

PART TWO. INFORMAL MARKETS

Finance and law both have their limits as ways of affecting real behavior. Much of economic life does not involve money, and many kinds of rules have nothing directly to do with legislators or judges. Some unofficial financial and legal systems can compete successfully with official ones, and trying to reform what already works may make little sense. Even those reformers who seek only to regulate or deregulate official financial institutions, however, should be aware of the unofficial activities that impinge on these.

Simple distinctions like formal/informal (or modern/traditional, or official/unofficial) can obscure as much as they reveal. Unofficial systems have their own formalities, if not in bureaucracy or regulation then in tacit convention or etiquette; and official ones have their informalities too. A four-box matrix with two kinds of finance, and two kinds of law, would quickly fill up with arrows in all directions. The world is messier than that.

But there are some patterns in the picture. This section of the report concentrates on the kinds of law and finance conventionally called informal, suggesting ways in which they interact, or don't interact, with the kinds most call formal. Whether at macro or micro levels, an enormous variety of groups, networks, and categories carry out financial activity and its regulation. No professional or academic training -- be it in law, finance, or the social sciences -- can by itself prepare one adequately to understand their rules, rationales, and mores, since these can involve language, kinship, ethnicity, politics, or religion. A few social and cultural principles may, however, help a sensitive observer to understand the rules and strategies of finance in a setting not wholly familiar.

In any setting, existing cultural, financial, and legal practices may have subtle rationales behind them and are likely to be adapted to their contexts in complex ways. Aside from the major ethical issues involved, any legal or financial reform intended to change popular custom is likely to be harder to carry out than it seems at the outset. The more intimately an existing practice concerns family, land rights, religion, or ritual -- in short, the closer it comes to home -- the more likely any attempt at reform will backfire in some unforeseen way.

Participants in unregulated systems may have reasons to keep these so; and reliable information about these, or about a program's effects on them, is usually easier to gather by delicate means (participant-observation, semi-structured interviews, etc.) than by the kinds of surveys that people in many parts of the world find too rigid or blunt.

Everyone who participates in a "reform" should have a stake in its success -- whether economic, political, or social. Persons without a positive stake may find cause to try to sabotage it. Nor should one underestimate the power of covert political interests to abet or transform any program of official action. An aid agency's attempts to promote reforms are likely to be locally perceived, rightly or wrongly, as culturally, politically, or commercially self-interested; and these public perceptions are easily manipulated by those who feel left out.

I. FINANCE WITHOUT FINANCIERS, AND FINANCIERS WITHOUT LEGAL REGULATION?

There is no country, society, or culture without finance or economy, but how discrete it is, how well it works, and whose interests it serves all vary widely. Saving, loans, and investment take many forms, not all of which involve money or moneylike instruments, and not all of which can or should be regulated. We begin with the simplest and most obvious. Money is not always looked upon as something to accumulate or keep liquid. It can also be something to get rid of, or to keep inaccessible.

A. NONMONETARY SAVING

Below are listed some of the nonmonetary forms savings can take. Saving in these ways may predate or outlast monetary saving, or supplement it. Monetary saving does not necessarily replace nonmonetary saving and should not be planned as an attempt to "capture" it.

- Land, housing: "real" property. Population growth in nearly every country augments its value.
- Trees, crops, livestock. Their growth or reproduction rates commonly exceed bank interest rates (though their risks too may exceed those of bank savings).
- Resalable hard goods (household furnishings, tools, machinery, etc.). These can serve practical purposes while storing wealth, and they tie up capital only where not borrowed and lent themselves.
- Specialized or "intermediary" currencies: perhaps metal rods, salt blocks, trading cloth, coupons, tokens, food stamps, poker chips, etc. Some of these may serve as "intermediary" currencies, that is, items exchangeable

for some goods or services but not others.

- o Quasi-monetary goods: Precious metals, jewelry, cowries, etc.
- o Debts collectible, in cash or kind or intangible forms. Voluntarily deferred wages are a form of saving that often escapes official notice. Labor and political favors owed are hard to count or measure.

People most everywhere prefer to keep their wealth in more than one form. Their reasons for diversifying their savings can include:

- o Reducing risks of many kinds, including that of devaluation and confiscation.
- o Sheltering wealth from taxation.
- o Avoiding envy, criticism, and accusations from neighbors or others. In many societies (and not just preliterate or nonindustrial ones), conspicuously accumulating wealth exposes one to witchcraft accusations or related dangers. Such perceptions, where they exist, are often rooted in their own complex rationales and resilient to "modern" secular schooling.

B. HOARDING

Public money hoarding is not usually easy for government authorities to control. Nor may these have good reason to do so: in a sense, cash hoarding represents an interest-free loan by the hoarder to a government -- or indeed, if inflation is taken into account, a loan with negative interest.

Hoarding itself occurs in many ways: burial, locked boxes or safes, and break-open containers for deposits only. In politically unstable, persecuted, or war-troubled areas, concealability and mobility matter much. Even in peaceful areas, for instance currently in Senegal, The Gambia, and other African countries, locked or sealed containers may be used to defend money from close kin, including spouses; and not least importantly, from one's own temptation. (Break-open containers in these settings are not just a children's concern like North American "piggy banks.") Indeed, many people pay cash for the boxes, suffer inflation losses, and forego bank interest to remove the money from their own hands this way. Where found, these containers may signal a potential demand for local savings banks. Hoarding can help maintain the value of a currency by limiting the total amount in circulation, but at the same time it deprives others of the money's use.

Where a government abruptly switches currencies, as in a recent Nigerian instance, hoarded wealth leaps out of hiding for quick conversion. Where authorities try to foil illegal operators by switching currencies and capping the amounts individuals can bring in for conversion, as in that case, individuals are likely to respond by simply dividing up their money among their kin, friends, or neighbors, and sending these along in their stead.

C. LOANS, ENTRUSTMENTS, AND THE MANY FORMS THEY CAN TAKE

Loans and entrustments too can take many forms that may not be commonly called loans or credit. These may include, to name just a few:

- Protracted or delayed marriage payments (bridewealth, dowry). Bridewealth is important in most African countries; dowry is important in many Asian and southern European countries.
- Ceremonial or other long-term reciprocities, or generalized redistributions.
- Loans of land, livestock (fostering or long-term lending), labor, tools, etc.
- Share contracting (e.g. sharecropping).
- Intangible obligations and favors.

It should not be assumed that any potential player in finance is without existing obligations. Everyone has debts and obligations already, even before or without receiving institutional credit and the new debts that it must entail. These existing debts and obligations may not show up in questionnaires or other formal surveys.

Most nonmonetary loans and entrustments, for instance marriage payments and sharecropping arrangements, are extremely difficult or impossible for governments to control. Much effort has been wasted in trying to do so.

Money is not always the best form for savings, loans, or other transactions. These are some of the possible drawbacks of cash for its possessor or saver:

- Material uselessness.

- Physical vulnerability (to theft, fire, water damage, etc.).

- Divisibility. Unless held in notes of large denominations (or in unopenable boxes, banks, etc.) cash presents constant temptations to be frittered away.

- Contestability. Money's divisibility, impersonality, and partial fungibility (discussed below) can subject it to competing demands of kin, neighbors, solicitors, etc.

- Inflation. This may be long-term or situation-specific (e.g. in famines). It is one of the best reasons to get rid of money.

- State control. Money is subject to devaluation and sudden currency switches.

- Taxability (if held in registered institutions).

- Country specificity or "softness" of currency. The smaller and more dependent the country, the more border and exchange regulations are likely to matter to its people.

Some of these features, of course, can be both pros and cons, if not for transactors then for others indirectly involved. Money is often proscribed for a particular gender, age, or religious status. Cultural norms vary enormously on these points and in some parts of the world are still poorly documented or understood.

These can be added disadvantages of keeping money in banks or other financial institutions:

- Inconvenient access: Need for expensive and time consuming travel, restricted opening schedules, queues, minimum balance requirements. Institutional restrictions on withdrawals (often a feature of mobile banks) add to the problems in case of emergencies. In rural areas inaccessibility is commonly the biggest reason for disuse of banks. It can far outweigh considerations like interest rates (which, in any case, rural people or those with little schooling often know or understand far less well than urbanites or better schooled people do). Evidence from various countries in Africa south of the Sahara suggests that, regardless of arithmetic abilities, rural people tend to have been far more concerned about their money's accessibility and safety than about interest rates.

- Communication barriers: Language, literacy, and numeracy barriers. Opaqueness of regulations to public.

- Possible untrustworthiness of strangers in the institutions. Such fears (whether well grounded or not) are often related to ethnic, linguistic, or racial differences. In many countries, tellers or clerks in even the largest financial institutions commonly request bribes, unregistered commissions, or political favors.

- The possibility that written records of savings or investments will be made available to kin, creditors, or other claimants.

- Possibility of closure, bankruptcy. Information may be unavailable on an institution's history, or on records of other institutions like it.

The list is not to suggest, again, that well run and properly regulated financial institutions can offer no advantages over other forms of saving. It is rather a caution.

D. MONEYGUARDING ("INFORMAL" DEPOSIT TAKING)

People in remote areas, or people engaged in illegal or semi-legal activities, may have many reasons not to hold onto their money or other wealth themselves, but to entrust it to kin, friends, neighbors, or specialized or semispecialized informal bankers. Examples are Kenya, The Gambia, and other African countries where rural people commonly entrust their cash savings to their elders or to wealthier neighbors, just as others hoard their own away, to remove it from their own temptation... and to shelter it from their spouses or other kin or neighbors.

A permutation of moneyguarding is the practice whereby an individual makes the rounds daily among market stalls or shops to collect earnings as deposits. Ghana and Nigeria have noteworthy examples of this mobile personal banking. Another is the pattern whereby wage or salary workers request their employers to withhold wage or salary payments and let them accrue.

In many countries, moneyguarding has never been closely or specifically regulated; in some it remains unrecognized by officialdom. It, may, however, fall under contract laws set up for other purposes, or banking laws. Are there rules or understandings about interest? About use of money held? Are there limitations on liability in case of loss, damage, or theft?

Are depositors often cheated and therefore in need of protection?

As the prevalence of the saving techniques above suggests, it is wrong to assume a simple "liquidity preference" or "illiquidity preference". For the most part, people like to keep part of their wealth removed from contestability and their own temptation, but they also like to be sure they can get at it in emergencies. This is a fine but vital line.

E. POSTDATED CHECKING

A postdated check -- that is, a check dated in such a way as to require a delay before presentation -- is a kind of promissory note. Check postdating as a form of credit occurs in many countries in eastern and southern Asia, in Latin America, and at least parts of Africa, in contexts where banking is practiced but where overdrafts are prohibited or hard to arrange. Borrowing by postdated check, repaid at par, can save the borrower from paying bank interest. In an inflationary economy, indeed, it means a real interest gain to the borrower and a loss to the lender (as does any other loan repaid at par). Hence lenders may insist on positive nominal interest if only to break even in real terms. Often the value of a postdated check is adjusted to conceal an interest charge from authorities who may disapprove of it.

Government authorities who seek to regulate postdated checking may be doing so to increase their own control over public borrowing and lending, and not necessarily for the public interest. Two kinds of legal and administrative measures available to such an end are rules allowing checks to be presented at any time, regardless of the date written on them, and punishing writers of bad checks. The popularity of postdated checking depends on lenders' confidence in legal or financial sanctions against bad check writers. Some countries that prohibit imprisonment or other criminal penalties for debt none the less allow imprisonment for writing fraudulent checks. Where postdated checks bounce, and criminal penalties are imposed, these become, in effect, penalties for debt. The two kinds of laws should thus be made to agree.

> Example: Research in the early 1970s in the Mercato of Addis Ababa Mercato (Addis Ketema), one of Ethiopia's most important market areas revealed postdated checks to be the most common way of securing credit between wholesalers and retailers, and between retailers and their customers. Under the Ethiopian Commercial Code, Art. 854, which was copied from French civil law and the Geneva Convention, a bill of exchange was required to be marked as such, with both the date of issue and the date of payability. A postdated check could not legally be used for this purpose but was payable on demand, regardless of the date marked on it. Most Addis

Ababa bankers, however, did not know or heed this legal distinction: they refused to pay checks until the dates marked on them. The Penal Code then in force permitted punishment including imprisonment for fraudulent check writing (Arts. 656, 657, 742) . But the Constitution of 1955 prohibited imprisonment for debt unless the borrower was able but just unwilling to pay (Art. 58). Merchants felt secure lending against postdated checks mainly because they knew borrowers feared a possible sanction of imprisonment. Most merchants interviewed said that when they found postdated checks to be bad upon presenting them, they informed the police. The possible misunderstandings thus multiplied: borrowers, lenders, bankers, police, and courts could all be operating by different rules. Disputes and lawsuits about debts were legion.

Possible official ways of solving the problems included (1) eliminating the rigid legal distinction between checks and bills of exchange, by amending the Commercial Code, (2) lengthening the grace periods allowed for presentation of checks, and (3) educating bank customers about the legal difference between checks and bills of exchange, and issuing them with special forms for bills of exchange, and perhaps even (4) amending the Penal Code or Constitution.

In practice, the problems were commonly solved by elders' conciliation and arbitration, which small entrepreneurs tended to prefer to the much slower, more expensive, and more impersonal formal courts.[1]

Mainly but not entirely beyond legal regulation, postdated checking is likely to remain a popular form of credit, complementing, substituting for, and in some ways outperforming institutional finance.

F. MIGRATION AND REMITTANCE

The importance of migrations and remittances, both within and across nations, should not be overlooked as a means of financial intermediation and of poverty alleviation. Border controls and red tape in public and private banks make transfers, and thus dependents's lives, harder.

Some resource-poor societies, countries, or parts of them depend heavily on these flows for their livelihoods. Usually kinship is the crucial link (though other ties like neighborhood of origin may also be invoked). Examples are Mauritanians depending on kin in Senegal, or Senegalese in France; or Somali with kin in Yemen, and Yemenis with kin in Saudi Arabia. People in host societies variously both depend on, and feel exploited by, immigrants who come to work and remit money out. Ethnic, linguistic, racial, and religious politics often enter the picture.

Rural-urban migrations may be circular, and the remittances involved may flow both ways, as in the common African and Latin American instances where urban migrants send money home and receive food at other times. Postal money orders are in many countries a crucial way for labor migrants to transfer money to relatives at home. Police roadblocks in many countries make cash difficult and risky to carry between town and countryside, or between mines or plantations and distant rural homes. Political instabilities affect both the postal services and road transport, for instance in Zaire, where both have recently been fraught with risks. In some countries, for instance Kenya, the risks of losing cash to armed police or soldiers at roadblocks has exceeded the risks of losing cash to postal authorities.

In many countries it is hard to remit or receive money across borders. International migrants from African countries commonly effected these remittances by entrusting cash to travellers, for lack of other familiar or available ways. Not only may this practice mean long delays, but it also puts senders, receivers, and even carriers all at the mercy of border authorities who may be corrupt or prebendalist. International aid may have a greater role to play in making cross-border money transfers easier for labor migrants and their families. Some of the diverse means to do so include conditionality to cut governmental red tape, diplomatic and transport sanctions on ports or airports, guarantees on bank transfers across borders, or retraining programs for administrators and bankers.

Just as a financial system intermediates between people by shifting resources from place to place, it also does so by shifting them from one time to another. Roadblocks, cut power lines, borders, or currency controls may block migrations or remittances, but they do not necessarily block intermediation over time.

G. LONG-TERM, INTERGENERATIONAL MONEY TRANSFERS

These transfers may take forms like school fee payments or marriage payments on behalf of junior kin, reciprocated many years later, or made under the understanding that the recipient will do likewise for a subsequent generation. Or they may take the form of contributions to expenses for labor migration, in expectation of eventual remittances.

Intergenerational transfers like these can serve some of the same functions that pensions, social security, and life insurance serve in industrial societies with more mobile populations. As formal mechanisms, insurance and pension funds are rarely used in many countries, or in rural parts of them (as in most of rural Africa south of the Sahara), but in such places transfers between kin of different generations tend to be extremely important.

Transfers over time, in forms like intergenerational bequests and entrustments, may not be subjected to the same kinds of controls as transfers over space. Transfers within families are hard to regulate by law or public administration, and in some settings it may be pointless to try to do so. More positive measures like establishing new "formal" systems of pensions, social security, and life insurance may serve, among others, several kinds of people unserved by the more traditional reciprocities, including members of elites who do not wish to share with younger kin the amounts expected of them, and including pariahs and outcasts.

Credit, debt, and savings commonly function in subtle ways as insurance for borrowers, lenders, or depositors, without this functions's being articulated as such. Concepts like these do not always translate neatly between languages or cultures.

H. LESSONS FROM MERRY-GO-ROUNDS

Local "informal" associations for saving and credit take an almost infinite number of forms: single purpose, multi-purpose; rotating, non-rotating; for production, investment, ceremonies, or emergencies. Varied, too, are the terms on which they collect and pay out: with interest or without, or with fixed or variable contributions, and (if they rotate), fixed or variable order of rotation. In rural settings (and sometimes in urban ones), many kinds of institutions combine financial and non-financial functions. This is often particularly true in countries with recent colonial legacies, where institutions set up for one purpose are used for quite another in addition or instead, sometimes as a matter of pride or self-esteem.

Small local contribution clubs are <u>hard or impossible to regulate</u> by law or public administration, and it usually makes little sense to try. Indeed, their freedom from control and red tape is one of their great virtues, and they can mutate to avoid these. Many governments have wasted much effort trying to discourage them as primitive, or to outlaw them. (In some countries, such associations even thrive within the very ministries concerned.) Where laws and administrative decrees favor women's groups for grants, loans, or other sought-after favors, some groups may yet include men as "ghost members," and even be dominated by them, without presenting their names on documents to be submitted to authorities. The same applies for race, ethnicity, class, etc. Merely imposing a rule, or lifting one, may not redirect the real flow of resources for long.

Contribution clubs are often important to people without access to formal banks, but they are not merely a poor substitute for formal banks. In many countries, some of the same people (for instance, Gambian bank or finance ministry clerks themselves) use both simultaneously, for different reasons. Evolutionary notions about progress from one form of saving or credit to another (or similes about "graduation") are likely to be ethnocentric or otherwise flawed. But certainly people often want more options than they have.

We look now at one type of contribution club, the rotating saving and credit association (ROSCA), as an example of self-regulation. This kind of group occurs, in patchy distribution, all over the world, often where banks are inaccessible or untrusted, and it suggests lessons for semi-formal and formal finance. The ROSCA is known by a thousand names, for instance the merry-go-round, tontine (French) or Esusu (Yoruba). Its workings may be quite simple: a group of people agree to meet at regular intervals (weekly, bi-weekly, monthly), or to have one member make the rounds instead, to pool contributions from all members (a shilling or dollar each, for instance) for one member to take the lot each time, until everyone has had a turn. Saving and credit are combined in the same transactions: which function the group serves depends only on one's place in the cycle. The groups also serve as a form of insurance for members' emergency cash needs. Among other things, a ROSCA'S gatherings may be parties in which the borrower is honored. Where these associations meet and conduct their transactions in full view of all members, graft or other corruption can be very difficult.

The ROSCA is well suited to serving trading and consumption needs. It is not, however, well suited to most agricultural purposes, because of the seasonal covariance of incomes and expenditures in farming settings, that is, everyone's wanting to withdraw or to contribute at about the same times of year. Some ROSCAS in rainfed farming settings suspend operations in the lean season each year.

What makes ROSCAS and comparable associations cohere, and to continue functioning where they do, is the social pressures members exert on each other. Usually the members must have something else important in common: age, gender (often female), kinship, neighborhood, employer, marketplace, place of worship, other affiliation, or mix of these. If this is so, then when one member misbehaves (e.g. by taking the pool early in the cycle and ceasing to contribute), the others are likely to have their own ways of getting even -- often outside the context of the group or its meetings. The incentives, then, are not just economic, but also social or political.

For individual members, the ROSCA can provide a way of defending savings from the day-to-day claims of kin and dependents as these savings accumulate. To many who live in tight rural communities, especially, this function is crucial in saving for large or "lumpy" purchases. When receiving one's take, the group or its representatives may or may not provide supervise its use by general agreement.

Peer pressure to repay is <u>not a mere substitute for collateral</u>. In some settings, it may work better, as for instance in parts of rural Kenya and some other African settings south of the Sahara, where farmland titles and livestock have proved unworkable as collateral for bank loans (see section on collateral) but rotating saving and credit associations have flourished.

Rotating saving and credit associations minimize the risk of inundating borrowers with unrepayable debts, since all funds lent are internally generated by members' own savings. The need for regular contribution screens out borrowers who are not serious. Having deposited money in the group gives its members <u>incentive to participate and to watchdog</u> its management. In these different senses, rotating savings and credit associations can be self-regulating.

A <u>lesson</u> is that credit often works best when combined with savings. This may be particularly true in rural areas where transport and communication problems make supervision of lending institutions difficult.

Whether groups of rotating credit and savings associations can be effectively organized into larger ones is in many areas unknown. Also poorly understood are the potential needs for, and roles of, law and regulation in these larger associations.

Savings-and-loan cooperatives occur almost worldwide and take unregistered, untaxed forms as well as more "formal" ones.[2] Some of their main lessons resemble those of rotating saving and credit associations. One is that self-help and cooperative groups tend to last longer where members self-select and organize and manage the groups themselves, than where the groups are implanted by authorities from a government or aid agency. Another is that financial institutions are most able to serve local needs when lending is based on previous saving and thus less likely to swamp borrowers in debts.

I. MONEYLENDING

Moneylending may or may not be carried out by specialists; moneylenders may also be relatives or friends, landlords (as in parts of India), wholesalers (as in Senegal or The Gambia), or retail shopkeepers (as in much of inland Africa, where money is lent). Despite the connotations of the English term "moneylender," such persons may or may not charge interest. Also, they may or may not take savings deposits too. Strictly speaking, moneylenders also include banks and some international aid agencies (some of which are popularly misidentified as "donors").

Smaller-scale moneylenders evade controls easily. Usury laws, designed to control small and large lenders alike, have a history several centuries long in European countries and others where European acts have been copied (as have, for instance, the British-based Moneylenders Acts in Kenya, Nigeria, The Gambia, and other former colonies). They have usually been designed for the protection of borrowers, rather than of lenders or savings depositors. Their main problem is that interest rates specified in one time or place are often inappropriate to another, given different rates of currency inflation, different transaction costs, different norms concerning defaults, and so on. More is said about usury regulation below.

J. MERCHANT LENDING

Merchant lending in most societies is a vital and pervasive part of commerce, but in some it can be a tool of social exploitation too, and as such it may need either regulation or deregulation to serve the ends of all parties fairly. Merchant lending can include loans from buyers to sellers, or from producers to consumers -- or vice versa. Loans may occur in cash or kind, and may or may not be linked to land, labor, or other resources. Often merchant credit takes the form of a series of lenders and borrowers, for instance where wholesalers lend goods to retailers and these lend to consumers, or where urban buyers lend money to rural buying agents and these lend cash or farm inputs to farmers against the promise of crops to be harvested. A common rural variant of merchant lending is pre-harvest loans for consumption (prets de soudure, hungry-season loans), on crop lien security. Since the loan and repayment take different forms and involve shifting prices, these loans may involve usurious interest (though see section on moneylending). Other related merchant lending links capital with labor (money lent, work repaid) or with land (money lent, land rights risked as pledge or mortgage collateral). Small-scale merchant finance may also take forms like rental, leasing, hire-purchase, installment plans, or others not translatable into English.[3]

Retail lending may require regulation where a firm holds a monopoly and monopsony in the most important commodities and consumer goods locally accessible, as for instance with "company stores" in frontier communities, plantations, or isolated factory or mining towns. In settings like these, personal and family overindebtedness to the firm can be a major social problem. To prevent debt bondage, laws or rules about finance may require interlinkage with (or substitution by) others about labor. It is important, in formulating or revising such regulations, to <u>consider the perspectives of both borrowers and lenders, the place of credit and debt in their lives, and the importance of the official and unofficial powers borrowers and lenders have over each other and their families and communities</u>.

K. PAWNBROKING

Like moneylending for repayment in specie, pawnbroking may be carried out by specialists or nonspecialists. It is practiced mainly, though not exclusively, in impoverished urban areas. It is also important where borrowing and debt <u>per se</u> are religiously discouraged (as for instance in predominantly Mormon parts of Utah).

As with moneylending acts, many former British colonies have adopted <u>pawnbroker acts</u> straight from British law. These have been designed to protect pawners or pledgers from usury. Here again, interest rate ceilings may be inappropriate where inflation rates are high -- if such regulation is to mean anything in such settings, the interest rates specified may need periodic adjustment. Other terms of lending, for instance concerning timing or the nature of collateral, may also be inappropriate to the local context.

But many kinds of pledges or pawnings may be untouched by pawnbroker acts. These may include pledges or mortgages of land, crops, trees, animals, or even humans against money loans. Like other moneylending, pawnbroking may be difficult to regulate in practice.

II. INTEREST AND USURY

A. ASSESSING FAIRNESS

What one individual, society, or legal code calls interest, another calls usury. Differences between the two depend on the nature of the transaction, the degree of gain, the intention to exploit, and other circumstances -- and, not least, on translation and ideology.

Before trying to judge interest charged by local moneylenders as fair or usurious, the following factors should be taken into account to understand <u>the lenders' point of view</u>:

- Inflation. Is the "real" interest rate still as high as the "nominal" rate seems when inflation is taken into account?

- The opportunity costs of capital. What else could the moneylender be doing with the money, and with what alternate reward?

- Overhead or administrative expenses. What does it cost the moneylender to keep track of accounts, or to pursue defaulters?

- Risks of default or protracted delay. Is there a kind of "high risk premium" built into an interest rate or ratio that seems high on surface?

... and <u>the borrowers' point of view</u>:

- Economic or other coercion. Is temporary or longer-term distress forcing the borrower to accept any available money on unfavorable terms?

- Alternative sources of capital. Where else might the borrower obtain similar capital, an on what terms?

- Comprehension of loan terms. Are the conditions being made clear enough to the borrower before a loan? Does the borrower have the arithmetic to understand the amounts and interest rates concerned? Does verbal or written agreement at the time of borrowing really indicate a deep and thorough understanding of the likely consequences of default? Is the borrower likely to overlook contingencies, (for instance deaths in family and funeral expenses, or fire or theft of property) that might arise before the loan is due?

- Seasonality. Is the borrower's income likely to accrue as steadily as loan interest owed? Who controls the timing of sanctions in the event of delayed repayment or default?

- Limitations. Is there anything to prevent a debt's accruing interest indefinitely? (Is there, for instance, an effective statute of limitations, or an effective religious law or custom about debt forgiveness?)

- Differential influence over witnesses and likely arbitrators or conciliators. In the event of a default, is a relatively poor borrower going to have the same negotiating or bargaining power as a relatively wealthy lender? The same access to legal advice, information, and advocacy?

- Recourses in event of failure to repay. Whom might the borrower turn to for help in the event of failure to repay (e.g., kin who can take over the debt); and is this help itself likely to be genuine or exploitative?

- Uneven power to inflict harm. Are the consequences of a default far worse for the borrower than for the lender, as in the case of a land pledge or mortgage?

... and finally <u>the viewpoints of others concerned</u>:

- Pre-existing debts and obligations. Who already has rights or claims on the borrower's resources? These need not be of the same kind or of comparable scale to take precedence when it comes time to repay.

- Overlapping rights. Who besides a borrower holds rights, claims, or interests in any property being used as collateral? Are the parties standing to gain from a loan the same as those standing to lose from seizure in the event of a default?

- Local norms about repayments.

B. INTEREST RATES AND RATIOS

Another consideration, subtler but no less crucial, is that in many cultures, loan profits are not usually locally conceived as taking the form of linear "<u>rates</u>" at all, but may be understood instead in terms of <u>ratios</u> of interest to principal. Interest may thus be understood as accruing independently of time elapsed between loan (or deposit) and repayment, or increasing in seasonal or annual jumps rather than in linear fashion. <u>What matters may be not the speed at which interest accrues, but the amount it finally adds up to in the end</u>, and the ratio of this amount to the principal. In a popular Sene-Gambian understanding, for instance, a long-term loan at a low rate of interest may be considered objectionably usurious while a shorter-term loan at a higher rate may not. In many parts of the world, including most of the Islamic world and much of Africa south of the Sahara, interest that accrues indefinitely is considered unnatural. In these contexts, time is <u>not</u> necessarily money. This is often more matter of cultural convention than of level of schooling, though both may be relevant. Some societies have unofficial "statutes of limitations" pertaining to credit and debt, that is, unwritten conventions that interest-bearing loans of a given type that age beyond a certain point should be forgiven.

Even where a population follows and believes in the principle of "rate" calculus conventionally used by large international and national lenders, many may remain unaware or only dimly aware of how quickly interest accrues or compounds -- through denial or misinformation if not innumeracy -- or be perpetually tempted to borrow beyond their means. The current example of United States credit cardholders, both urban and rural, is a case in point. Another is the history of North American farmers, particularly smallholders, who have lost their farms through mortgages, combined with eventual harvest or price vicissitudes -- a story paralleled in many countries, sometimes with more tragic results.

Where loans are tied to pledges and mortgages, moneylenders do not necessarily treat collateral merely as a way of securing loans. Some, indeed, use moneylending more as a device for land predation. Loan sharks (like financial saviors) may include multinational banks as well as streetcorner moneylenders, though their methods and terms differ.

However rich, urban, or schooled, no population can categorically be assumed able to calculate accurately the risks of borrowing, let alone predict or control the specific eventualities to ensue. People do not usually give adequate weight to risks of misfortunes not recently experienced. This does not mean that anyone else necessarily knows better, or should make these predictions on behalf for potential borrowers, official or unofficial. Rather, it implies that some legal or institutional safeguards against predatory lending and unwise borrowing, and against individual arrogation of family resources in mortgages, may have a place. They may be needed especially in rainfed farming areas where land is titled and can be pledged or mortgaged.

III. COLLATERAL AND "SECURITY"

A. COLLATERAL: A DOUBLE-EDGED BLADE

Loan collateral can be a useful device in some circumstances, but also a dangerous one for the borrower if not also the lender. It may be movable or immovable. It may take the form of salaries, crops, tools, land, buildings, trees, animals, vehicles, or machines, to name only a few variants. (In a few tropical African societies and elsewhere, during famines and other crises, children too have sometimes been used as collateral for loans, or been pledged in betrothal.)

Property or income may be charged or encumbered against a loan as an undeadlined pledge, redeemable at any time, or a deadlined mortgage (the term mortgage comes from the Old French terms for dead and pledge). In many societies -- perhaps most -- the idea of a deadlined mortgage has never been acceptable, has only recently become so, or is hotly debated.

While people of some societies deem pledges and mortgages a natural outgrowth of business, people in others consider them unethical, particularly where land mortgaging is involved. Generally, the mortgage system is better suited to urban and industrial settings than to rural ones, and most poorly suited to rainfed smallholder agriculture. Here, because interest debts accrue more steadily and surely than farm yields or product prices -- either or both of which may remain low for several consecutive seasons -- mortgages tend ultimately to benefit lenders at borrowers' great expense.

B. POSSESSORY AND NONPOSSESSORY PLEDGES AND MORTGAGES

Pledged property may variously be expected to remain with the pledger (a "nonpossessory" pledge) or to shift into the hands of the pledgee (a "possessory" pledge, as in pawning). Cultures differ markedly in preferences for one kind of pledge or another. In some West African settings, for instance, including much of Nigeria and Ghana, a possessory pledge involving land as security is locally deemed normal (particularly where cash-cropped trees are concerned); while in most of East Africa, by contrast, it is not.

Relative advantages of nonpossessory pledging or mortgaging include continuity of holding, and of incentives to work on or develop the asset. On the other hand, where the borrower hands over the collateral to the lender for the duration of the loan, it is harder for the borrower to sell or dispose of rights to a third party without informing the pledgee or mortgagee.[4]

Some West African national governments have tried to legislate away possessory mortgages in favor of nonpossessory ones. The outcomes of these "reforms" are not yet fully known, but the signs are inauspicious; and to the extent that anyone pays attention to the new laws, these may discourage potential lenders from lending at all.[5]

C. PLEDGING, MORTGAGING, AND LAND TENURE "REFORM"

As noted above, loan collateral can be a useful device in some circumstances, but also a dangerous one for the borrower if not also the lender. What, if anything, should be used as collateral in institutional loans is a delicate one, for it must be valued enough to provide incentive for repayment but not so highly valued that an attempted confiscation will be politically or socially explosive.

Attempts to speed up "evolution" towards a mortgage system and land market tend to be fraught with problems and have sometimes produced results quite opposite to those intended.

Probably no kind of development intervention is harder or more likely to go awry than rural land tenure reform -- whether undertaken with capitalist, socialist, or other intentions. Attempts to make individual rights in farmland or grazing land "secure" with private titles issued by governments have tended to worsen problems they were designed to solve.

> Example: The government of Kenya has carried out rural land titling nationwide since the mid-1950s. Among the many explicit aims of the program has been to provide, in negotiable title deeds, a new form of security for farmers and herders to use for loans.
>
> But there are major problems unsolved, and probably unsolvable, by law or administration. In the high potential areas of the country where lands are densely settled, farming people customarily subdivide family holdings in inheritance and succession from one generation to the next -- a reasoned adaptation to land shortage. So they tend to live near, or even surrounded by, many of their kin. They bury their dead at their homes, and they base their land claims partly on the presence of family or lineage graves on that land, and spiritual attachments to it. These patterns are of course unchangeable by regulation.
>
> A land mortgage system does not fit into this context. When an alien lender (for instance the parastatal Agricultural Finance Corporation, or a commercial bank) tries to foreclose on a mortgage and auction off the land, those kin/neighbors of the person being dispossessed see to it that no buyer can move onto it. Often violence ensues, sometimes right at the auction. In some Kenyan languages, land seizures by creditors or their agents are popularly spoken of in the same terms as military raids.
>
> As a consequence of the tensions surrounding land mortgages, the Office of the President has sometimes issued standing orders, in politically sensitive periods, forbidding financial institutions to foreclose. Additionally, the financial institutions have tacitly blacklisted or banned some parts of the country, for instance crowded Kisii District, from land-secured lending, acknowledging that the land freehold-collateral system has proved hopeless and counterproductive there. Some senior politicians prefer, however, to maintain the freehold-mortgage system, partly as a stick to wield over potential dissidents.
>
> Farmers, meanwhile, and particularly land sellers, have little incentive to keep the government up to date with their land transactions and subdivisions. The register quickly obsolesces. A market in land titles becomes divorced from the market in land. Double dealing and confusion proliferate, sometimes again causing bloodshed.
>
> One of the main lessons from the Kenyan experience is that a legal land tenure "reform" does not expunge and

> replace the existing system(s) of tenure, but only adds beside it a new set of rules and procedures that may clash with it. The local and alien tenure systems, with their conflicting underlying philosophies, together create a situation in which rich, educated, connected, adroit, or unscrupulous individuals may play both systems off against each other to dispossess less fortunate persons without increasing production or productivity.[6]

The story is far from unique. Many colonial and national governments in Africa south of the Sahara have tried similar titling experiments, since the turn of the twentieth century, at local and lately national levels. The results, so far as they have been recorded, have almost uniformly disappointed both farmers and financiers. Individual titling appears to have reduced more than increased security of tenure for smallholders in most titled areas, productivity has not measurably risen (though some important questions remain unanswered), and most of the titling programs have eventually been abandoned.[7]

"Security of tenure" or of ownership is not necessarily the same as possession of official title. This caution applies particularly to land. If land will end up sold or mortgaged away as a result of being individually titled, its tenure is not secure.

It is naive to assume people will always keep their own long-term interests, and group interests, in mind when borrowing. It is particularly naive where rainfed smallholder agriculture is concerned. Where a land mortgage system catches hold in a rural area, the broader outcomes may include absentee landlordism, landlessness or land poverty, hunger, and resulting political instability. A crucial question is whether a country or region has enough industries to absorb the newly landless or land poor as they are dispossessed by mortgage. Kenya and most other African countries do not.

D. MANY ALTERNATIVES TO COLLATERAL

Lenders have many ways to secure loans without requiring collateral like land, and some of these are likely to require more regulation than others. Many English financial terms about collateral, and the underlying concepts, are better suited to Euro-American or industrial conditions than to those of other parts of the world or to agricultural or pastoralist areas. "Collateral substitute" implies that nothing is as good as collateral, whereas actually, in some contexts, other systems of guarantee work better.

- <u>Previous investment or savings</u>. Having savings deposits or shares in an institution gives a borrower an incentive to repay its credit. Having deposits also help ensure that <u>other depositors</u> will exert pressure on the debtor to repay, in so far as they may fear the institution's collapse or adverse effects on their own savings.

- <u>Character acquaintance</u>. Lessons from local, informal finance suggest that knowledge of a borrower's character is a more important or potentially successful criterion than often acknowledged. This method too is a keystone of the Bank Rakyat Indonesia (BRI): rural employers have been used to recommend particular employees to the Bank and its branches for loans. With jobs on the line, borrowers under this system have an added incentive to repay.

- <u>Ritual agreements</u>. In some societies, a written contract can mean far less than a ritual oath; a shared drink, toast, or animal sacrifice; or an arranged marriage to cement a deal. Nor are the latter conventions necessarily disappearing. In many settings, however, the written and unwritten forms of contract or agreement seem to have accommodated each other.

- <u>Cosignature or other individual guarantee</u>. If the borrower has, say, no salary to attach, it may none the less be possible to persuade a third party to guarantee a loan with his or hers.

- <u>Peer group guarantee</u> In a revolving credit fund the principle can be simple: no member can borrow until one or more previous members have repaid. Peer pressure (often based on other, nonfinancial links between members) ensures repayment. Interesting possibilities are now being explored in small scale and informal enterprise finance, some following or adapting the models of the Grameen Bank of Bangladesh, Accion International in several Latin American countries, or the now defunct Partnership for Productivity and its surviving spin-offs in some African ones. In most settings, lending programs and organizations based on peer group pressure work better among women then men. Reasons may include not just gender differences in character and cooperativeness (which may vary from one society to another) but also men's greater mobility in many societies: where members of a group come and go, they have more trouble controlling each others' cooperation.

- <u>Liens on products controlled by monopsony</u>. The important point to remember about product liens is that the product lent for need not be the same as the one used to anchor the loan. In Kenya, for example, loans for maize, whose nature as a staple food makes it nearly impossible to control, have been best anchored by a parastatal monopsony on coffee (with repayment rates of over 90 percent, as compared with only 20 to 40 percent with food crop or cotton liens). Farmers who grow both crops lose a market for their coffee if they default on their maize loans.

Also to be remembered is that a "permanent crop" (such as a tree or bush crop) makes a better anchor than an annual one, since a long growing period represents a sunk cost to the grower, and since it is easier for lending authorities to keep track of trees or bushes (and thus to estimate their yields) than crops replanted seasonally. Analogous principles may obtain for different industrial products or trade goods.

Unfortunately, while allowing buyers free entry into a product market can provide healthy competition in some ways, it hurts a crop lien system, since producers can then more easily borrow from one buyer and sell to another, defaulting on their loans.

- Salary liens. These are used in many countries as an effective form of loan security for borrowers in steady jobs. In Kenya, for instance, where the Agricultural Finance Corporation have been reluctant\to lend to small farmers on the basis of crop or land security alone, it commonly lends to farmers or others with salaries. Of course, this method entails a possible elite bias.

- Written contracts. European or American-trained financial and legal specialists tend to prefer written over unwritten for accuracy of record and ease of enforcement. But these may have disadvantages too, if not for the parties directly concerned then for others around them. One reason is that literacy and numeracy skills are never equally distributed in a population. Where wealthy lenders are more likely to have had access to schooling than poorer borrowers, writing can allow one party unfairly to exploit another.

  But there are other, more subtle considerations. Unwritten contracts are more likely than written ones to rely on witnesses (though written ones sometimes use these too). Oral witnesses' memories and words are mutable over time. Keeping them on one's side can sometimes require payments or bribes. But it can also require generally acceptable social behavior, since a witness is more likely to turn against someone generally disliked. Having orally contracted credits or debts can thus help keep borrowers' or lenders' social behavior in check. The benefits to society may be hard to discern or measure, but no less important for it.

- Exposure and public image. Borrowers have informal "credit ratings" as well as formal ones. Being publicly known to have defaulted on an institutional loan may damage a borrower's future access to other, even more important, local sources of finance or other help. Public exposure and embarrassment of defaulters may thus scare others into repaying.

- Promise of future loans. But the carrot can work even better than the stick, and where borrowers are poor or powerless it is likely to be a happier solution altogether. The hope of being able to borrow more in the future, or to keep the door open for other favors, makes a strong incentive to repay. This is a often a good reason (among others) for lenders to start small and lend in gradual increments.

Combining the right sticks and carrots is an art whose execution seems to vary in every setting, and for every kind of borrower, lender, and loan. There is no one right way.

A word must be said about the threat of force or physical punishment as an alternative sometimes resorted to, unfortunately, in financial affairs. It may be hard for borrowers who have seen others forced to repay (or had property confiscated, or been victims of violence) to gauge the probability that it will strike them personally. As with public exposure, then, sometimes the occasional sacrificial example frightens a large number into repayment. For this reason, among others, physical sanctions for loan defaulters are used in more countries and cultures than some realize. In this context it is worth remembering that in many countries, jail sentences may mean torture, malnutrition, or worse. To this extent finance and law tie directly into human rights.

People may not need loans, lenders may not need collateral, and collateral may not need to take forms like farmland -- let alone human beings themselves. Depending on the context, there may be many better alternatives to each. Where borrowing already involves serious risks like loss of vital collateral, it is important that borrowers be allowed maximum flexibility in the timing of repayment.

IV. NORMS ABOUT MONEY AND REPAYMENT: OTHER SOCIAL AND CULTURAL CONSIDERATIONS

Cultures differ in the degree to which they deem interest charges and loan defaulting sinful, hurtful, or self-shaming. They also differ radically in the kinds of social bonds deemed worthy of honoring by loans, entrustments, or repayments. Moreover, they differ greatly in whether they consider money a commodity worthy of such respect.

> Example: Kenyan herding peoples including Maasai, Samburu, or agropastoral Luo use long-distance cattle entrustment between individuals as a way of showing deep friendship, cementing political alliances, and sharing resource endowments. The same people seldom look upon cash loans (particularly state bank loans), as deserving comparable respect or honor. Among Luo, at least, loans in kind are more easily recovered than loans in cash. None the less, Luo tend to look upon even state loan defaults as a matter of morality. Historically closer to church than to state, they tend to avoid state creditors but to turn instead to church or prayer for guidance or protection when in arrears.
>
> Kikuyu of Kenya, by contrast, a farming and trading people, seem to hold cash in higher esteem as a medium of saving, exchange, and trust. As a people formerly much favored by government, they tend to keep in closer touch with official creditors. As state agricultural lenders attest, Kikuyu in arrears, even on state loans, appear to turn more often than Maasai or Luo to the secular authorities to help solve their problems. Of course, there are many exceptions to these simplified depictions.

A. LANGUAGE, INTERPRETATION, AND THEIR PRACTICAL IMPORT

Many English financial terms may have no exact equivalents in other languages. In African languages, for instance, these terms frequently prove hard or impossible to translate, or require more than one translation. They include such seemingly (to some) basic words as capital, income, saving, credit, investment, profit, interest.

> Example: In the Mandinka language spoken in parts of The Gambia and parts of neighboring West African countries, "credit" or "loan" can be translated as nfu, a helping loan, or ndonto, a profitable business loan. Questionnaire surveys may show 20%, 40%, or 60% of the rural economy to take the form of "credit," depending on how the term is translated and in how many different ways the question is asked.

Other terms that may lack precisely comparable terms in other many languages include these units of aggregation, among others: firm, business, enterprise, corporation, partnership, farm, family, and household. Even where English terms apply to local forms of commercial groupings, they may fail to capture their essence.

> Example: Mauritanian entrepreneurs in other West African countries, who commonly lend money or sell trade goods on credit, commonly operate their businesses not as corporations with closed membership, but as networks of kin whose members frequently travel back and forth between place of origin and place of work, in such a way that there are always several present but the working membership of an enterprise shifts frequently. In such cases a "firm" or "business" or its "proprietorship" can be hard to define, regulate, or aid with (say) credit or saving facilities or training. These businesses grow with little assistance from outside the Mauritanian trading diaspora, and they operate by complex internal rules and conventions that outsiders have seldom understood.

Difficulties in translation are not merely communicational or semantic issues but are often the tip of the iceberg, indicating real and fundamental differences in ways of thinking about financial and economic affairs in relation to social, political, and religious life.

Financial terms and concepts often gain or lose ethical implications and stigmata when translated between languages. Some financial terms euphemized in English, for instance "interest" (for loan profit), "business" (for a profitseeking group or activity), or "invoice" (for a bill, or a demand or request for payment), regain negative moral charges when translated into other tongues. As noted below, "interest" translates into Arabic and Arabic-influenced languages (for instance Swahili, lingua franca of East and central Africa) as riba, which also means excess, usury, unjustified gain, or sinful lending practice -- things prohibited in the Qur'an and other sacred Islamic scriptures and teachings. "Profit," on the other hand, translates into Arabic by terms that carry morally neutral or positive implications.

Translation problems like these often cause misunderstandings where rules or laws classify financial institutions. The French term société (for company) or affaire (for business), for instance, imply profit-seeking while their most direct English translations (false or diverged cognates) may not. Such issues of translation can be particularly important in countries like Canada or Cameroon, where attempts have been made to unify legal codes but where more than one official language is used; and where voluntary or semi-voluntary organizations are concerned.

English terms for corruption, like bribery, kick-backs, nepotism, etc., may or may not translate into terms with comparably sinister overtones. For example, in East Africa, small bribes translate into Swahili as <u>chai</u>, or tea, which can also mean a tip (in a sense comparable to the French <u>pourboire</u>, for [to] drink). <u>Baksheesh</u>, similarly, derives from the Persian <u>baksidan</u>, to give, not necessarily a stigmatized term. In some languages "nepotism," not necessarily disparaged, either does not translate, or translates into terms with more positive connotations, like "family loyalty" or "duty to kin."

In many African and other languages (including many Bantu languages, like KiSwahili), terms for "buy" can also mean "sell"; terms for "lend" can also mean "borrow". The context determines the meaning. (Or the words may stem from the same root and be quite similar, as in Shona, a Bantu tongue in Zimbabwe, where -<u>tenga</u> means to buy and -<u>tengesa</u> means to sell.)

Obviously, laws or rules about exchange, where translated, should take account of multiple meanings and connotations that may attach to terms in one language but not another.

B. KINSHIP AND "NEPOTISM"

As noted above, North Americans untrained in cultural and social studies tend to misunderstand or underestimate the role of kinship in finance and law in countries outside their own.

Kinship systems take many forms, but are often crudely classed as several kinds: patrilineal (where descent and affiliation are traced through the male line, as in most of China or most of East Africa), matrilineal (where descent and affiliation are traced through the female line, as for instance in parts of southern Ghana, Malawi, or Zambia, and some Himalayan areas), or cognatic or bilateral (where they are traced through both, as in much of the Americas, inner island Indonesia, and the Philippines). Ambilineal (as among Amhara of Ethiopia) and bilineal kinship are rarer kinds. Of course, most peoples combine more than one kinship principle in some ways. Marital alliances can be at least as important as descent in many areas, but it is important to remember that these are alliances of groups or categories as well as of individuals.

Patrilineal and matrilineal kinship can often activate bigger groups (clan sections, lineages) than bilateral kinship can -- for instance for ceremonial or emergency funds. They are often accompanied by a high social value on elderhood and ancestorhood, which lend themselves to systems of informal arbitration and conciliation by known kin or clan representatives, sometimes in preference to courts. They are often found in societies with deeper historical awareness or memory in their written or oral traditions (as in China or many parts of tropical Africa). "Long term" economic planning in such cultures may be reckoned in generations or centuries rather than years. These are some of the reasons why Europeans and North Americans have sometimes misunderstood or underestimated the role of kinship and social structure in the LRJ and financial life of other regions.

Kinship or fictive kinship can be a basis of financial trust and cooperation (as in the nineteenth and twentieth century Rothschild Bank, in many contemporary New York investment banks, or some Arab banks and finance ministries), of patronage, clienthood, and protection (as in the Mafia or the Union Corse), or of efficient but pernicious financial exploitation (as there again, or in the governments and financial institutions of 1980s Iraq or Zaire). What some call "nepotism" (from the Latin nepos, nephew) can variously be a basis for speed and efficiency -- allowing one member can act quickly on another's behalf without cumbersome bureaucratic clearances (as in the historic Rothschild example) -- or in another way a "barrier to entry" into a market.

Neighborhood favoritism is usually rather easier than extended kinship for "western" trained financiers, administrators, and jurists to understand, but it too has its complications, for instance among urban and town Yoruba of southwest Nigeria, where community is defined not just by where one lives but also by the town one comes from. Here migrants' hometown-tie associations play critical welfare and insurance functions.

C. ETHNICITY

Ethnicity too is easy to misunderstand as a one-sided basis for financial or legal trust and solidarity, or a pernicious form of favoritism and prejudice. (Here it means ethnolinguisic affiliations, rather than race -- ethnic solidarity is sometimes disparaged as "tribalism"). Nearly all parts of the world have minority groups who specialize in money and finance, or in particular other kinds of trade: Lebanese in West Africa, Ifugaos in the Philippines, Antioquenos in Colombia, Gujeratis in Kenya, Chinese in Malaysia, and so on. Often these are groups or categories prohibited from owning land or other productive resources (as with Jews in 19th century Poland.)

But often the rules affecting their operations are unwritten cultural norms. These may be as overt as zoning for places of business, or as subtle as norms prohibiting intermarriage with majoritarians (and thus fueling clannishness internally or discouraging easy lending between groups). These issues are politically explosive, but economically and culturally critical.

> Example: In a large international aid agency in Washington, a meeting was held in 1988 to discuss ways of promoting private enterprise in West African and other poor countries. One member raised the suggestion that ethnicity should be paid attention to, noting the important though ambivalent role of Mauritanian immigrant traders (locally sometimes called "Naars," a disparaging term) in Senegal and The Gambia. The suggestion raised considerable indignation, and some anger, around the table: it seemed to raise the specter of racism and perhaps that of religious prejudice. But at the first ensuing coffee break, however, a senior agency officer turned to a neighbor and whispered, between cupped hands, "Just between you and me, I never let anyone lend to the Naars."

Whose laws and rules should govern the financial behavior of migrants and minorities can be a thorny problem. The publics of numerous African countries, for instance Nigeria, Cameroon, and Kenya, have long undergone uncertainty about whether, or when, national laws derived from European codes and civil law are waived for Muslims or others with their own religious laws -- and whether either of these should yield to indigenous local laws or habits. Generally speaking, in such countries, the more closely the laws pertain to family life and its finance (as in marriage, divorce, succession, inheritance, and some kinds of trusts) the more likely the "customary" and religious laws, as locally interpreted, have seemed to hold sway -- whether with government consent or not. Officials of governments and aid agencies are best advised to devote their regulatory efforts to easier ends.

D. POLITICS AND PATRONAGE

Finance is never entirely divorced from politics. At international, national, and local levels, credit means patronage, particularly if subsidized. It is variously used as a way of cementing military alliances, luring votes, buying or indenturing supporters, placating potential opponents, and otherwise extending power or authority. Subsidies seem perennially and almost unremovably to be part of the attraction, for both borrowers and lenders. The favors of lending are often only temporary and can often be disservices in the end. To suppose that any country or financial system can be free of political "allocation" of loans or subsidies is unrealistic, though ways may be found to reduce or rechannel these.

Financial terminology brings to light many political problems. Credit implies debt; credit is debt. Documents that discuss one without the other imply either of two things about their lenders: that they are shortsighted or that they have considered only the lender's point of view and not the borrower's.

Numerous other terms in conventional development parlance turn out to be "lender-centric." "Discipline" (as in "loan discipline") and "supervision" (as in World Bank "supervision missions") imply relations of inequality between lenders and borrowers in a way the latter may find arrogant and objectionable. "Loanee," for borrower, makes the lender seem the only active agent. "Moral hazard" is too often applied to borrowers, and not often enough to lenders. A term like "delinquency," though etymologically correct in application to loans, casts aspersions on borrowers who may have been lent to irresponsibly or forced by poverty to not repaying.

These are not just academic or intellectual distinctions. Where terms like these are common, they are signs deeper conceptual problems that are likely to cause practical and political ones too.

E. EXECUTIVE OVERRIDES AND "CORRUPTION"

Where international donors and lenders have sought to curtail credit allocation and liberalize interest rates, these have sometimes proved very resilient to change in practice. In these or other countries, senior politicians -- including, in some case, heads of state locally perceived as being above the law, or people operating on their behalf -- seem to continue exerting pressure on government and parastatal lenders to keep subsidizing loans, for political or personal purposes the public may or may not well understand.

In Kenya, for example, after an official liberalization of interest rates in mid-1991 under international aid agency pressure, many public and private financial institutions' lending interest rates rose only slightly or remained at the same low, subsidized levels. Officers in the agricultural finance corporation complained that they were afraid to raise their lending rates because they believed the President would disapprove. Zimbabwe underwent a similar official liberalization in 1989, with comparable early results in practice.

Holding down interest rates on loans also indirectly holds down those on deposits, discouraging potential savings depositors. Seasoned politicians in many countries know that debt forgiveness too is a powerful tool of patronage -- and they may try to time the announcements to occur just before elections. But since political and economic acts like these can be religiously motivated or morally rationalized, they may not be easy to regulate.

To some heads of state and senior politicians and bureaucrats, loans and a land mortgage system represent a set of tools for consolidating power and patronage as well as wealth. Among other things, their control over parastatal lenders allows them, if they wish, to hound prominent dissidents publicly as loan delinquents, to humiliate them publicly with auction threats, to force them into begging for protection, and thus to be able to purchase their public political submission or support on favorable terms. These are among the vested interests behind some politicians' support of freehold tenure and land collateral. Not all peoples believe their political leaders to be subject to laws about financial affairs. Executive power may reverse or make exceptions to laws, and even make them irrelevant.

Similarly, in other societies, some religious leaders are perceived to be above secular financial laws, or tacitly exempt from them. In Senegal, members of particular Islamic brotherhoods (notably the confrérie Mouride with its several main networks of disciples) have wielded considerable power and influence over the highest executive officers of government as well as over legislators, partly by lending to the government and to politicians and civil servants themselves.

Many cross-cultural misunderstandings have surrounded the issue of sanctions for mismanagement or "corruption" in financial institutions. In some countries, graft or other theft of money are not normally treated as offenses punishable by dismissal, but only by transfer to another post; whereas political offenses like verbal insinuations about a head of state may occasion immediate firing or worse. Some theft is economically coerced by low or irregularly paid salaries. Many African government functionaries could never support families (let alone courtiers and clients they perceive as essential for their survival) in capital cities on their salaries alone. Some are tacitly required to skim off bribes or kickbacks for superiors as a condition of their jobs. Some financial corruption, then, is better understood as prebendalism -- though of course not all of it.

V. RELIGIOUS REGULATION OF FINANCE

It is well to be aware of, and respect, differences in the ethical and religious underpinnings of financial thought and practice, as well as of law. These religious laws and moral codes, found in many different societies, should not be assumed to be straightjackets from which financial actors should be freed. They can abet and organize finance as well as encumber it, and they are subject to local interpretation, debate, and manoeuvre -- and many aspects of this vast topic remain poorly understood in legal and financial circles.

Many different religions place strictures on usury (defined in many ways), gambling, speculation, excessive or extortionate trade profits, or theft -- though not always all at once. Most of the major religions also have rules or norms to encourage tithing, alms, charity, and debt forgiveness, though again, not always together. Some proscribe interest charges. Other religions (for instance Mormonism) proscribe going into personal debt. Broadly speaking, religious strictures influence finance more by proscription than by prescription. But both can have important implications not just for "informal" financial life, but also for institutional banking, insurance, stock markets, and commodity speculation.

Some of the most sensitive religious issues in finance concern relations between majority groups and trading or banking minorities that may variously be consigned special financial or commercial tasks deemed beneath the dignity of the former, or else subjected to special discriminatory commercial restrictions. Restrictions may enter black-letter law or remain in the realm of unwritten or unspoken; and these issues are not just economic but also political, cultural, and sometimes racial. It is hard to make any general recommendation beyond sensitivity and tolerance on these points.

International aid for finance or its regulation may become complicated when nongovernmental organizations from one religious tradition work in a country or culture where another prevails. Many of these groups have shifted from grants to credit and lately savings too as standard program elements. A number of the larger NGOs nominally attached to particular faiths are in fact nondenominationally staffed and have been able to work peacefully and effectively, as secular relief and development agencies, in countries where different religions predominate. An example is Catholic Relief Services in the Gambia and other mainly Muslim parts of Sahelian West Africa, where religious thought and practice combine elements of islamic and indigenous african origin and issues like interest and usury are much debated. In settings like these, religious pluralism permits cautious experimentation in finance.

Religious rules and norms are often manipulated, altered, or honored in the breach, rather than being static structures or rigid constraints. In many settings, too, people have commonly switched religions or sects because of differences in their economic dictates or their applications. Three African examples illustrate the last point. Among Giriama-speakers of coastal Kenya, palm tree owners shifting from a palm wine to a copra export economy, and making unprecedented profits, have found that conversion to Islam helped protect them from redistributive local customs.[8] Among Lala-speakers in Zambia, rising entrepreneurs have found conversion to Seventh-Day Adventism congenial to their individualistic aspirations.[9] Luo in western Kenya wishing to grow tobacco as a new cash crop have shifted between Christian churches to participate in contract farming in which they borrow inputs from the British-American tobacco company and repay in kind. Whether religious rules help or hinder finance or its regulation depends entirely on how they are being used.

A. ISLAMIC AND "WESTERN" FINANCE: INTEREST, USURY, AND RISK

Not all peoples perceive the same degrees of separation between finance or law and other worldly affairs, or between these and spiritual ones. Islamic societies deserve particular attention in this respect, since Muslims prefer to think of their religion as pervading all aspects of life, and its sacred law (shari'a) as governing secular as well as spiritual matters. Below are summarized some bare essentials of Islamic law and custom concerning finance. Some areas of frequent misunderstanding between Muslims and non-Muslims, and among Muslims themselves, are indicated.[10]

Muslims perceive the Shari'a to be in essence a divinely authored legal and moral code revealed by the Prophet Mohammed, rather than a secular one made by humans. The Qur'an and the Sunna (records of the Prophet's life, words, and unspoken indications of approval), the keystone scriptures variously known to Muslims by written or by oral rendition, encode both ethics and practical prescriptions; and all Islamic teachings about financial law are held to be based on ethical norms (as compared, for instance, with precedent in Anglo-American common law, or the statutory decrees of French civil code).

Two main kinds of financial dealings are generally forbidden under Islamic law: (1) transactions with advantage or deferment deemed unfair (in Arabic, _riba_), and (2) transactions involving special kinds of risk, understood as gambling, speculation, or dealing with unevenly shared information (_gharar_). These are examined in turn, and in the course of describing them we touch upon banking, securities exchange, and insurance.

Riba. Sometimes translated "interest" or "usury," but also having wider meanings, _riba_ refers to gain from certain kinds of exchange deemed unfair and thus prohibited by sacred law. In its broader meanings in Islamic thought and in Arabic, _riba_ refers not only to loans with "interest" but also to certain kinds of barter, money exchange, and sale, whether immediate or with deferment. But in common and translated parlance, it refers mainly to what anglophones call "interest" on loans. All such gain is prohibited -- in ideals if not always in real behavior -- and the Qur'an promises that the guilty will be punished in the afterlife. _Riba_ does _not_ include profit from buying and selling; such profit is condoned in the Qur'an and should not be confused with loan profit.

To what loans and commodities does the _riba_ prohibition apply? First, it appears always to have applied to bartered lending (i.e., commodity against commodity, without the use of money) and has more recently been applied to money as this has become more common. In the Sunna it is noted that the _riba_ prohibition applies specifically to gold, silver, wheat, barley, dates, and salt. But in nearly every school of Islamic thought (or sect), other currencies and commodities are also included by virtue of particular material or abstract likenesses or analogies (or '_illa_, efficient causes) to these. Different schools of Islam vary considerably on which commodities are included in the prohibition, and on the reasoning behind the comparisons drawn. They focus variously on the criteria of whether or not the loan and repayment commodities are

- used as currency
- edible
- weighable or measurable
- storable
- produced from the soil
- named with the same terms as the six commodities specifically noted
- of the same origin as other forbidden loan (_riba_) commodities (e.g., from the same animal), or having the same use
- otherwise analogous to _riba_ commodities.

Money and money-like instruments are usually likened to gold or silver in Islamic thought and are thus taboo for loan interest. Some schools of Islamic thought allow particular commodities to be exchanged simultaneously but not with a time lag. It also matters whether an exchange is repaid in like commodity; where not, the exchange may be expected to be simultaneous to avoid suspicion of unfair advantage to the lender. Some interpretations relax the prohibitions in cases of urgent need or in cases where the loan is for productive purposes.

As far as transactions between Muslims and non-Muslims are concerned, the rules can depend on where the transactions take place. Non-hostile non-Muslims who are settled in Muslim territory (_Dar al-Islam_, or abode of submission to the holy way) in Arabia are usually expected to follow the Shari'a; and most, but not all, Islamic schools profess that Muslims settled in non-Muslim territory (_Dar al-Harb_, or abode of war) must also abide by this sacred law.

The moral and spiritual opprobrium attaching to riba has given rise to elaborate conventions, in many and probably all Islamic countries, for reclassifying or adjusting the nature of loan gains to be, or to appear (to humans or to divinity) as, profit-sharing rather than interest. Some of these are known in Arabic as hiyal (sing. hila), "legal devices" -- a term which some have considered a euphemism itself.

Gharar, the second main concept of Islam of direct importance to finance, concerns profit-seeking activities with unacceptable kinds of risks, gambling, uncertainty, or unfairly shared information. As commonly interpreted, it affects insurance, life annuity, securities exchange, gambling, and many other kinds of activities and organizations.

At the risk again of oversimplifying, the essence of gharar prohibition, at least in its origins, is to protect persons against entering into transactions in which their own knowledge or wisdom may be inadequate to safeguard their own interests. Muslims believe that this prohibition grew out of the Prophet's long experience in trade, observing trickery or exploitative dealings between ruralites and urbanites with different mores and exposures.

> "The idea of protecting the weak against exploitation by the strong led to the elaboration of a rule of general application, commanding that any transaction should be devoid of uncertainty and speculation, and this, according to learned men and legal scholars, could only be secured by the contracting parties' having perfect knowledge of the countervalues intended to be exchanged as a result of their transaction, otherwise there is an unacceptable degree of gharar. Thus, what was intended to be a religious precept was transformed into a worldly rule which affects a great proportion of secular transactions."[11]

Muslims have varied much, over time and place, in the strictness of interpretation and application of this general, broadened principle.

Without attempting a full or precise listing, these kinds of sale dealings may fall under gharar:

- Selling what one doesn't own or possess in hand (like unshot quarry, or the Brooklyn Bridge).
- Selling what the buyer can't see or hasn't inspected (like swamp land sold by phone as farmland).
- Arranging a transaction with an unknown time of

completion or fulfillment (whether upon one's accidental death, or "when my ship comes in...").

- Exchanging a good or service at an unknown or unspecified price (as in commodity futures to be redeemed at the price of a fixed time hence), or in unspecified amount (a load, a bag of unknown size), or in uncertain future condition (unripened crops sold too far in advance).

- Unloading what one knows is sick or dying (whether an animal or an enterprise).

- Buying or selling with a down payment, security deposit, or earnest money (which might not be mutually understood as adequate compensation for trouble or lost opportunities in the event the deal is not completed).

- Engaging in lotteries, casino games, or other games of chance.

Not all business risk, but only business risk with uneven or inadequate knowledge, is prohibited as gharar. To sum up several aspects of the ideal, the nature of good or service, its quantity, the price, the place, the probability of a change, and the timing should all be fairly known to both or all parties of a transaction, and under adequate control. Selling something that doesn't exist is gharar; selling something that doesn't exist but will certainly exist in the future is more debatable among Muslims.

Not just sales, but also rentals, loans, pledges, and other transactions may be gharar under certain conditions. Some kinds of donations, wills, and disposals by power of attorney may also be subject to prohibition.

Islamic financial law is not just about prescription but also about proscription, particularly concerning charitable contributions and tithes. Most notable is the Zakat, a kind of sacred property tax (without the negative connotations of other taxes) that is one of the five basic tenets or "pillars" of Islam. In one authority's words,[12]

> "Wealth is produced by the application of man's skill and labour to the resources which God has provided for man's subsistence and comfort and over part of which man enjoys proprietary rights, to the extent recognized by Islam. In the wealth that is produced, therefore, three parties are entitled to share: the workman, whether skilled or unskilled; the person who supplies the capital; and the community as representing mankind. The community's share in produced wealth is called the Zakat. After this has been set

aside for the benefit of the community, the rest is 'purified' and may be divided between the remaining parties that are entitled to share in it.

> "Zakat is the pivot and hub of Islamic public finance. It covers the moral, social, and economic spheres. In the moral sphere Zakat washes away the greed and acquisitiveness of the rich. In the social sphere Zakat acts as a unique measure vouchsafed byu Islam to abolish poverty from the society by making the rich alive to the social responsibilities they have. In the economic sphere Zakat prevents the morbid accumulation of wealth in a few hands and allows it to be diffused before it assumes threatening proportions in the hands of its possessors. It is a compulsory contribution of the Muslims to the state exchequer."

The state in the last sentence may, like other aspects of Zakat, be subject to different meanings. The Zakat is only one of Islam's various prescribed contributions from producers or accumulators to society at large, or to the poor.

B. ISLAMIC BANKING

Much debated both within and across cultures, Islamic banking attempts to bring financial practice into line with Qur'anic and other Islamic understandings about the nature of justified and unjustified profit. In essence, Islamic banks have either reformed their financial practices themselves, such that they do not need to charge or collect interest (for instance) but only share profits, or they have continued to conduct approximately the same practices as non-Islamic banks but have relabeled interest (or other prohibited practice) as profit-sharing or something else like service or administration fees).

Practices and nomenclature thus both continue to vary within Islamic banks, and what some Islamic bankers consider legitimate practice others consider morally dubious hiyal or even outright sin. Some argue, for instance, that interest becomes riba only when it reaches the double of principal, and others argue that interest is legitimate but compound interest is not. But strict constructionists say all loan interest is riba.[13]

As authorized in particular countries, Islamic banks have been attempting

> "musharaka (partnership), murabaha (cost-plus-profit contract), ijara (lease contract), ijara wa-iqtina' (hire purchase contract), qard hasan (interest-free loan), takaful (mutual guarantee) and mudaraba (commenda partnership [an arrangement with separate subpartnerships, one between bank

and depositor, the other between bank and entrepreneur)".[14]

Interest-free banking has been attempted, for instance by the Islamic Bank International in Denmark. Some Pakistani banks and their branches dealing with foreigners, within Pakistan or elsewhere, have charged interest (and thus excepted themselves to the principle about Muslim-Nonmuslim exchanges described above), apparently under a comparatively lenient Hanafi interpretation of scripture. To keep interest and non-interest income discrete, some such banks have consigned savings branches that dealt with foreigners to the custody of separate companies.[15] But some Pakistani banks rework or relabel interest as shared profit, i.e. legitimate profit from trade. The debates go on.

Experimentation continues within the banks to find ways of intermediating finance and profiting competitively without breaking transgressing Shari'a; but the task for Islamic bankers has not been easy, given other financial institutions' competition. Some noted Muslim religious authorities and financiers, but by no means all, have called for a new Muslim consensus on riba.

In closing this discussion of Islam and finance, in which we have sought to remain neutral in judgment, it is worth remembering that in any culture or religion, ideals and real behavior do not always coincide.

C. MONEY'S "FUNGIBILITY" AND LIQUIDITY IN QUESTION

Is money just money? Is it right to assume debtors will be able to draw freely upon all their monetary assets for repaying institutional loans, or that they will always willingly substitute any money for any other money? Some market theorists have assumed that money was uniquely and wholly fungible -- that is, that money was money, and what one doller (say) could do, another dollar could do as well. They assumed, moreover, that what made money special was its ability to be shifted from one purpose to another and substituted for other values. They inferred that money lent for one purpose might well end up in another (certainly true enough), and that debtors were always free to draw on any wealth they had available to repay their debts.

Recent research in many societies, from peasant to industrial ones, casts doubt on how widely shared the twin assumptions about money's easy fungibility and liquidity are, and it does so from cultural, social, and economic perspectives. It is now clear that people most everywhere impose distinctions between their moneys, earmarking moneys from particular sources for particular purposes.[16] Where they could, in theory, shift money quite freely from one purpose to another, they also, in actual practice, impose arbitrary barriers on it, for instance dividing sacred money from profane, short-term from long, male from female, or group from individual. Whereas some business training programs have sought to make micro-entrepreneurs separate personal money and business money into different pockets or distinct accounts, and to resist dipping into business funds for personal needs, many of these small-scale businesspeople turn out to have been dividing up their funds all along and practicing similar restraints, but along different lines of their own drawing. The point is not that earmarking is rational or irrational, but merely that in one way or another, people in every country and culture do it.

Becoming more evident too are one-way cultural turnstiles of cash flow. Some Muslim Gambians say that money gained in disapproved origin like riba lending must not be used to finance holy undertakings like the hajj (pilgrimage to Mecca) or to serve long-term family or lineage purposes. Among Luo-speakers of Kenya, as another illustration, norms and sanctions permit the transfer of wealth from male cash into cattle or into marriage payments, but not back out into liquid cash, except in emergencies. Money from selling family land or morally contested cash crops like tobacco is expected to be used only for particular purposes. Salary portions devoted to contribution clubs for funerals expenses are made unusable for anything else. Urbanites worldwide, of course, use special-purpose currencies like postage stamps, coupons, food stamps, or tokens; but they also earmark gifts and budget items. While sometimes abused and evaded, rules about earmarking blot money's liquidity.

The implications of the fungibility and liquidity issues for financial programs are profound and wide-ranging. They mean, for instance, that once a loan is received and put to a particular use, it may be socially unacceptable in local eyes to allow its repayment to its lender. These rules and conventions may overpower any sense of personal responsibility to an official creditor.

The social distance between creditors and debtors must always be taken into account before lending. What was once assumed to be "moral hazard" turns out instead to be more a question of conflicting moralities, with their own cultural and economic roots. Mutual, not just one-way, education between potential borrowers and lenders may help reduce further misunderstandings; but meanwhile, may the lender (as well as the borrower) beware.

D. A FINAL REMINDER

The quickly worsening problems of international debt suggest that development finance has generally overemphasized credit, and underemphasized saving -- and neglected the lesson that credit usually works best in conjunction with saving and investment. Savers and depositors need legal, regulatory, or judicial protection as much as borrowers or lenders do; but in the best financial systems, these are the same people and the deposits help safeguard the loans. Poorer people need protection from official lenders as well as unofficial ones, and from international lenders as well as ones in their communities. Both borrowers and lenders may do well to remember the words of that anonymous ancient sage, "When in a hole, stop digging."

VI. SUMMARY OF BRIEF SUGGESTIONS FOR POLICY AND PROJECTS

A. GENERAL

- Pay attention to unofficial kinds of finance, to the unofficial kinds of rules that structure it, and to the strategies used for evading these rules. These are usually best investigated by methods like participant-observation and informal or semi-structured interviewing, and best understood with much attention to local language and context.

- Avoid reforms that would require substantial changes in family life, land rights, religion, or ritual. They are the hardest kinds to implement and the kinds most likely to backfire in unpredictable ways.

- In attempting any reform, ask not only who might stand to gain, but also who might stand to lose and therefore wish to subvert the effort. Always consider the political dimension: might there be someone who thinks he or she can power or influence by playing upon public suspicions about a program's motives?

B. ASSESSING NEEDS FOR WAYS TO SAVE OR BORROW

- Never assume a people lacks ways to save or borrow. Borrowing, lending, saving, and investment may take subtle and overlapping forms, or forms only partly economic in nature.

- Do not assume savers have a liquidity preference. People may have good reasons to keep their wealth illiquid or out of reach of their kin, their neighbors, or themselves. They may also have good reasons to keep it in more than one form.

- For evidence that more means of saving money would be welcome, note clues like break-open containers, local moneyguarding (informal deposit taking), and requests for wage deferments.

- To help alleviate poverty in the poorest countries and regions, remember that these may depend heavily on international labor migrations and remittances, and seek ways to make these flows of persons and money easier. Intervention in these financial flows may take diplomatic, legal, administrative, or educational forms.

- Where postdated checking is common practice as informal credit, note whether laws about fraudulent checks are consistent with the laws about indebtedness. Assume, however, that postdated checking will be hard to regulate.

C. LEARNING FROM INDIGENOUS FINANCIAL INSTITUTIONS

- Assume that an institution set up for one purpose may serve other purposes entirely. Particularly in formerly colonial settings, where institutions may have been initially implanted, and their names imported, without regard to context, nominal and real current purposes of organizations often differ radically. Institutions ostensibly set up for single purposes often serve several simultaneously.

- Remember that organizations ostensibly composed of members of one category (as distinuished by gender, age group, occupation, or other criteria) may conceal "ghost members" of others too, particularly where national or agency regulations have stipulated aid be channeled to one of these categories only.

- Do not expect to be able to regulate contribution clubs (for instance, rotating savings and credit associations) by law. It is not a good idea to try to "capture" the savings of informal contribution clubs for formal institutions. If they aren't broken, don't fix them. Think instead of learning from the clues these provide about local financial needs, and of adding more or better <u>options</u>.

- Consider the solidarity group (peer-group pressure) system of loan security as likely to work best among disadvantaged categories: women, rural dwellers, and the poor.

- Where emulating the peer-group principle of rotating contribution clubs, remember that these tend to function best for purposes of trade and consumption, and worst for purposes connected with rainfed agriculture.

- Let members of solidarity groups select themselves locally. Their knowledge of their own characters and interpersonal chemistry is likely to surpass any outsider's.

- If lending to or through solidarity groups, be sure their members (a) are of comparable wealth and status, and (b) have <u>other</u> interests or activities in common, so that they will have ways of making each other cooperate.

- Institutional pensions, formal insurance, and "social security" (mandatory savings or pooling for old age or infirmity) are likely to prove welcome only where familial financial transfers do not serve these purposes already, but this need may be discernable only through experimentation.

- Remember that local forms of credit and debt can also serve in subtle ways as insurance.

D. LINKING CREDIT AND SAVINGS

- Expect credit subsidies to have perverse effects. If subsidies are desired, then instead of subsidizing credit (which means encouraging indebtedness), consider subsidizing savings or investment.

- Try to link credit with savings, as a general rule; and to require some financial, labor, or other commitment from potential borrowers. Doing so can help to screen out those not serious, give participants a real stake in a project or program, and add their scrutiny to its management.

E. INTERVENING IN MONEYLENDING, OR LETTING IT BE

- Do not automatically equate moneylenders with loan sharks, or high interest with usury.

- Expect usury laws (including moneylending laws and pawnbroking laws) to prove hard to enforce. Borrowers and lenders have many ways to circumvent them.

- Where trying to implement moneylending or pawnbroking laws to curtail usury, consider rates of inflation when setting limits on interest rates.

- Do not assume that all people calculate interest as "rates." Some prefer to think of them as ratios of interest (or increment) to principal, and not to suppose that "time is money."

- Where a company or public enterprise holds a monopsony or monopoly over rural consumption goods (as in the "company store"), expect to look for debt bondage or other exploitative lending that may require regulation.

- Expect that when a new "informal" form of finance (for instance, itinerant or marketplace deposit-taking) becomes very lucrative for local financiers, some government authority may exert pressure to illegalize it. Such moves may be motivated by desires to protect participants (such as, in this case, depositors). But such moves are sometimes attempted for the hidden purpose of capturing a market or trade for personal or governmental benefit, which may in turn be driven by officials' desires to be able to sell indulgences.

F. DELICATE ISSUES OF COLLATERAL AND SECURITY

- Remember that access to credit, particularly where mortgages are involved, can do borrowers as much harm as good -- and often far more. Mortgage lending is particularly dangerous in rainfed farming areas over the long term, and it can also be inappropriate to lands held by pastoralists. Do not assume that collateral needs to take the form of land titles.

- Do not assume that foreign intervention or new property laws can expunge existing systems of property rights, or speed up "evolution" toward private property and a mortgage system.

- Remember that property that will be sold, mortgaged, or gambled away once titled as individual property is not secure.

- Before moving toward any land tenure reform, ask whether the society or country has adequate industrial employment opportunities to absorb a land-poor or landless class safely. In many poor countries where such reforms are being attempted, the answer is no.

- Do not assume that loans require collateral to be secure. There are many ways of securing loans without it. These vary greatly by context.

G. NAVIGATING UNWRITTEN NORMS AND VALUES

- Take great care in trying to translate financial terms and concepts between languages, in research, regulation, or administration. Many concepts taken for granted in English simply do not translate into other tongues.

- Remember that norms and ethics about loan repayment may depend heavily on the familiarity and intimacy of borrower and lender, and on their mutual involvement in multi-stranded social networks. What is "moral hazard" to a lender may be common sense to a borrower.

- Be aware that "nepotism" and ethnic or neighborly "favoritism" are not necessarily only forces for inequitable advantage and accumulation, but can be forces for efficient finance too. They are usually hard to regulate or police away.

- Remember that financial credit usually implies personal or political patronage, and that the power to dispense it can be a coveted way of advancing the lender's self-interest. Attempts to regulate or deregulate interest rates are likely to be influenced by powerful vested interests, political as well as economic.

- Do not assume that all politicians or religious authorities are conceived of as subject to law or its enforcement.

H. RESPECTING RELIGIOUS DIFFERENCES

- Religious prescriptions and proscriptions concerning finance should be respected in all intercultural dealings. It should not be assumed, however, that adherents to a religion necessarily follow or wish to follow all the rules in their sacred scriptures or oral religious traditions.

- Nongovernmental organizations with religious origins or names, and dealing in finance, may or may not follow religious principles in these dealings.

- Islamic banks may vary in their interpretations of sacred laws of finance. Forms of exchange that some eschew, others practice eagerly. Key concepts like <u>riba</u>, <u>gharar</u>, and <u>zakat</u> deserve careful attention in their theory and in local context.

- Foreigners dealing in financial regulation in Muslim countries should take particular care to understand local ideas and practices concerning loan "interest" and usury, exchanges with unevenly shared information, speculation, or gambling. Concepts like "futures options," if ethically neutral in some cultures, are laden with powerful meanings and sanctions in others.

I. MUTUAL PROTECTIONS FOR BORROWERS AND LENDERS

- Do not assume that assumptions about money's "fungibility" are universally agreed upon in a culture, or that they are the same from one society to the next. Pay special attention to the ways people "earmark" money from particular sources or activities, for particular purposes.

- Do not assume that money shifted from one "sector" of the economy can flow as easily in the reverse direction, or that money lent will be necessarily be money collectible back.

- Remember that credit means debt. It always looks rosier at the front end, for borrowers if not also for lenders. Never take the answers to questions like "Do you want (or need) credit?" at face value. Usually if the same questions are pitched in terms of wanting debt, the answers are different.

- Remember that disadvantaged persons need protection from, as well as access to, lenders and other financiers.

NOTES

1. Source of case illustration: John Ross and Zemariam Berhe, "Legal Aspects of Doing Business in Addis Ababa: A Profile of Mercato Businessmen and their Reception of New Laws", African Law Studies 10 [1974]: 1-46 (see esp. pp. 32-5).

2. Discussed in Dimitri Germidis, Denis Kessler, and Rachel Meghir, Financial Systems and Development: What Role for the Formal and Informal Sectors? (Paris: Development Centre of the OECD, 1991), and Ohio State University, Department of Agricultural Economics, A Selected Annotated Bibliography on Financial Markets and Agribusiness Development in Sub-Saharan Africa (Columbus, Ohio: Department of Agricultural Economics, OSU, report to USAID/AFR/ARTS, 1992).

3. Many of these are discussed in Dimitri Germidis, Denis Kessler, and Rachel Meghir, Financial Systems and Development: What Role for the Formal and Informal Sectors? (Paris: Development Centre of the OECD, 1991). The authors find that of several regions studied, India has the most elaborate variety of what they call "informal" or "semi-formal" financial companies.

4. The point is taken from R.W. James, Tanzanian Land Law. Nairobi: East African Literature Bureau, 1971: 340-1. [To recheck]

5. See E.V.O. Dankwa, "The End of Pledges in Ghana?" Journal of African Law 33(2), 1989: 185-191. See also C.O. Olawoye, "The Question of Accountability in the Customary Law of Pledge", Journal of African Law 22, 1978: 125-135.

6. Case from P.M. Shipton, "The Kenyan Land Tenure Reform: Misunderstandings in the Public Creation of Private Property". In R.E. Downs and S.P. Reyna, Land and Society in Contemporary Africa (Hanover, New Hampshire: University Press of New England, 1988, pp. 91-135) and P.M. Shipton, "Debts and Trespasses: Land, Mortgages, and the Ancestors in Western Kenya," Africa 62(3), 1992, pp. 357-88. See also A. Haugerud, "Land Tenure and Agrarian Change in Kenya," Africa 59(1), 1989, pp. 61-90, and Jack Glazier, Land and the Uses of Tradition among the Mbeere of Kenya (Lanham, MD: University Press of America, 1984).

7. For a country-by-country survey see James Riddell and Carol Dickerman, Country Profiles of Land Tenure: Africa, 1986 (Madison: University of Wisconsin Land Tenure Center). For other comparative surveys see Shem Migot-Adholla, Peter Hazell, Benoit Blarel, and Frank Place, "Indigenous land right systems in sub-Saharan Africa: a constraint on productivity?", World Bank Economic Review 5(1): 155-75; and David A. Atwood, "Land Registration in Africa: The Impact on Agricultural Production" (World Development 18(5): 659-71).

8. Example from David Parkin, Palms, Wine and Witnesses: Public Spirit and Private Gain in an African Farming Community. Chicago: Waveland Press, 1994 (reprint).

9. Example from Norman Long, Social Change and the Individual. Manchester: Manchester University Press, 1968.

10. The discussion of Islamic finance and differences among Muslim persuasions roughly follows the outline of Nabil A. Saleh's Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar, and Islamic Banking (Cambridge: Cambridge University Press, 1986) and sums up some of his key points. See also Anwar Iqbal Qureshi, Islam and the Theory of Interest (Lahore: Ashraf, 1974), M.A. Mannan, Islamic Economics: Theory and Practice (Lahore, 1975), and M. Muslehuddin, Insurance and Islamic Law (New Delhi, 1982, reprint), and Maxime Rodinson, Islam and Capitalism (London: Allen Lane, 1974). Our discussion is also informed by field

interviews and observations in Islamic West Africa and elsewhere.

11. Saleh 1986 (op. cit.): 49.

12. M.A. Mannan 1986 (op. cit.): 253-4.

13. Qureshi 1974 (op. cit.): p. 95.

14. Saleh 1986 (op. cit.): pp. 89, cf. 101.

15. Saleh (1986), pp. 31-32.

16. See, for instance, Jonathan Parry and Maurice Bloch, Money and the Morality of Exchange (Cambridge: Cambridge University Press, 1989); Parker Shipton, Bitter Money: Cultural Economy and Some African Meanings of Forbidden Commodities (Washington, D.C.: American Anthropological Association, 1989), and on "modern" industrial and literate society, Viviana Zelizer. The Social Meaning of Money: Pin Money, Paychecks, Poor Relief, and Other Currencies (New York: Basic Books, 1994).